Putnam INVESTMENTS

Q1 2021 | Putnam Income Fund Q&A

Fund outperforms despite challenging interest-rate backdrop

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Longer-term interest rates rose substantially in February and March, contributing to an uptick in market volatility.

Strategies targeting prepayment risk helped the fund outpace its benchmark. Conversely, positioning in corporate credit detracted.

Expectations for a stronger U.S. economic recovery have sparked investor optimism while also raising the alert for possible early signs of inflation.

How did the fund perform for the three months ended March 31, 2021?

The fund's class Y shares returned -2.31%, outpacing the -3.37% result of the benchmark Bloomberg Barclays U.S. Aggregate Bond Index. Despite negative absolute performance, exposure to risks outside the benchmark helped the fund outperform on a relative basis.

What was the market environment like during the first quarter of 2021?

Encouraging vaccine news bolstered investor optimism about the strength of the economic recovery in 2021. A $1.9 trillion Covid-19 aid package signed into law by President Biden in early March provided a further boost to market sentiment. Rising prices for stocks and commodities also helped lift the overall market environment. However, concerns about the potential inflationary impact of additional stimulus on top of an already-recovering economy led to an exodus from government bonds. This drove longer-term interest rates higher and placed a degree of pressure on the credit market. After beginning 2021 at 0.91%, the yield on the benchmark 10-year U.S. Treasury note reached 1.74% by March 31. Similarly, the 30-year Treasury rose from 1.64% to 2.41%.

Within this environment, ascending bond yields weighed on investment-grade debt despite marginal spread tightening. [Bond prices rise as yield spreads tighten and decline as spreads widen.] High-yield credit, meanwhile, posted a modest gain, aided by better-than-expected corporate earnings and higher oil prices.

Not FDIC insured | May lose value | No bank guarantee

Which holdings and strategies helped the fund outperform the benchmark?

Strategies targeting prepayment risk contributed the most versus the benchmark this quarter, driven by our mortgage-basis positioning. Our mortgage-basis strategy reflects our view on the yield differential between prevailing mortgage rates and U.S. Treasuries. The strategy added value as spreads on agency pass-throughs tightened [meaning their prices rose relative to Treasuries]. Holdings of interest-only [IO] and inverse IO securities also contributed, benefiting from rising interest rates and a steeper yield curve.

Within our mortgage-credit holdings, commercial mortgage-backed securities [CMBS] provided a further boost to relative performance. Our positions in cash [as opposed to synthetic] CMBS increased in value as spreads tightened.

What about detractors?

A lower-than-benchmark allocation to investment-grade [IG] corporate credit modestly dampened relative performance. IG corporate spreads tightened marginally, resulting in a slight increase in bond prices.

What is your near-term outlook?

As the economy reopens amid the proliferation of Covid-19 vaccines, we believe gross domestic product growth will be robust, particularly in the second and third quarters of 2021. We're also anticipating a strong recovery in corporate earnings growth.

In light of expectations for sturdier growth, we believe U.S. Treasury yields could rise further this year. That said, we think the trend toward higher rates will be gradual as bond investors adjust their growth and inflation outlooks, leading to periods of market volatility.

In addition to interest rates and Covid-19 vaccine progress, we will also watch for any change in inflation metrics that may cause the U.S. Federal Reserve to shift its posture sooner than currently expected.

What are your current views on the various sectors in which the fund invests?

Looking first at corporate credit, we have a positive view of fundamentals and the market's supply-and-demand backdrop, but are more neutral toward valuation.

From a supply-and-demand standpoint, new issuance of IG corporate bonds in 2020 reached a record level of $1.7 trillion. We think new issuance is likely to decline substantially this year. Given that there is still strong demand due to the lack of yield globally, reduced supply could lift prices for existing bonds. Overall, we believe reduced bond issuance should be positive for the market's technical backdrop.

It appears that a significant amount of anticipated good news has been priced in by the market. As of period-end, IG corporate spreads had tightened considerably, making valuations in this sector less attractive.

Within the CMBS market, while there continues to be a degree of negative sentiment toward certain property types, the availability of Covid-19 vaccines has sparked optimism that social-distancing measures could be meaningfully eased by the middle of 2021. As a result, we continue to have conviction in the fund's CMBX exposure. [CMBX is a group of tradeable indexes that each reference a basket of 25 CMBS issued in a particular year.] We believe current valuations fairly compensate investors for existing risk levels and provide an attractive risk premium.

Fundamental credit analysis and security selection are particularly important in the current CMBS market environment. While some parts of the CMBS market will likely continue to struggle, there are CMBS backed by what we consider to be strong underlying collateral that have suffered amid widespread fear of the sector. We think many of these bonds represent attractive investment opportunities.

Within residential mortgage credit, against the backdrop of robust home sales and a rebound in mortgage originations, we continue to find value across numerous market segments.

In prepayment-sensitive areas of the market, we continue to find value in agency IO collateralized mortgage obligations, as well as in inverse IOs backed by jumbo loans and more seasoned collateral. Overall, we view prepayment-related opportunities as attractive sources of diversification for the fund.

Putnam Income Fund (PNCYX)

Annualized total return performance as of 3/31/21

Class Y shares Inception 6/16/94	**Net asset value**	**Bloomberg Barclays U.S. Aggregate Bond Index**
Last quarter	–2.31%	–3.37%
1 year	5.62	0.71
3 years	5.56	4.65
5 years	5.12	3.10
10 years	4.46	3.44
Life of fund	7.44	—

Total expense ratio: 0.60%

What you pay: 0.48%

Returns for periods of less than one year are not annualized.

"What you pay" amount reflects Putnam Management's decision to contractually limit expense through 2/28/22.

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. You cannot invest directly in an index.

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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 March 31, 2021, 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, unlike traditional debt investments, are also 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). 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 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. 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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Putnam Retail Management

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