Q2 2021 | Putnam Income Fund Q&A

CMBS strategy contributes, but falling rates become headwind

Michael V. Salm
Chief Investment Officer, Fixed Income
Industry since 1989

Brett S. Kozlowski, CFA
Co-Head of Structured Credit
Industry since 1997

Intermediate- and longer-term interest rates declined during the quarter, boosting fixed-income returns across market sectors.

Strategies targeting prepayment risk hampered the fund's relative performance, while exposure to commercial mortgage-backed securities notably contributed.

We believe the environment for risk-based fixed-income assets remains generally supportive but also recognize the potential for heightened inflation.

How did the fund perform for the three months ended June 30, 2021?

The fund's class Y shares returned 0.14%, trailing the 1.83% result of the benchmark Bloomberg Barclays U.S. Aggregate Bond Index.

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

After more than a year of pandemic-driven headlines, a massive rollout of Covid-19 vaccines during the second quarter led to an almost full reopening of the U.S. economy. With things slowly returning to normal, there appears to be a significant amount of pent-up consumer demand, which is being further fueled by government stimulus. We see evidence of this, for example, in the most recent consumer confidence levels.

With Covid-19 vaccines greatly reducing the risk of prolonged economic lockdowns, rebounding consumer demand sparked growing concerns about inflation. Despite this, intermediate and long-term U.S. Treasury yields declined during the quarter after rising sharply earlier in the year. The yield on the benchmark 10-year Treasury dropped from 1.74% to 1.45% during the quarter, while the yield on the 30-year Treasury fell from 2.41% to 2.06%. Possible factors behind the decline in rates include strong demand for longer-dated debt from investors overseas, the extent to which the economic reopening is affecting recent inflation data, and the U.S. Federal Reserve's ongoing bond-purchase program.

Not FDIC insured | May lose value | No bank guarantee

Lower interest rates drove fixed-income returns higher across market sectors. Investment-grade bonds managed to recover from losses suffered in the first quarter to post positive performance. High-yield corporate credit did even better, as yield spreads continued to narrow. [Spreads are the yield advantage credit-sensitive bonds offer over comparable-maturity Treasuries. Bond prices rise as yield spreads tighten and decline as spreads widen.]

Financial markets are forward looking. As a result, sectors that previously benefited the most from the reopening of the economy — such as airlines and leisure-related goods/services — declined amid profit-taking and increased inflation risk.

The price of oil rose on global markets by more than 25% during the quarter and, as of June 30, was up roughly 52% for the year, with the summer travel season underway. The prices of other commodities, including lumber, sugar, and corn, also rose markedly during the past year, but cooled off a bit in the second quarter.

Now that the U.S. economy has largely reopened, investors will have a keen eye on corporate earnings during the next few quarters. Market participants will also be watching for any hawkish shift in tone by the U.S. Federal Reserve, should inflation continue to move higher.

Which holdings and strategies hampered the fund's performance versus the benchmark?

Strategies targeting prepayment risk detracted the most on a relative basis. Faster-than-anticipated prepayment speeds of the mortgages underlying our holdings of interest-only collateralized mortgage obligations worked against their returns this quarter.

The fund's interest-rate positioning also proved negative. Duration was shorter than that of the benchmark, giving the fund less relative rate sensitivity during a period when interest rates declined.

What about relative contributors?

Exposure to commercial mortgage-backed securities [CMBS] — through cash bonds as well as synthetically via CMBX — notably aided relative performance, as spreads tightened. [CMBX is a group of tradeable indexes that each reference a basket of 25 CMBS issued in a particular year.] Also, bond selection within investment-grade corporate credit modestly contributed versus the benchmark.

What is the team's near-term outlook?

Overall, we believe the environment for risk assets remains generally supportive. Our optimism is grounded in the rapidly growing percentage of Americans receiving Covid-19 vaccines, sustained government stimulus, and the continuing recovery of the U.S. economy. Risks to our generally constructive outlook include any new negative developments with Covid-19 and policy missteps from global central banks.

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.

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

Within this environment, we have a positive outlook for the fundamentals and overall supply-and-demand backdrop of investment-grade corporate credit. Our view on valuation is more neutral, however, given the relative tightness of yield spreads as of quarter-end.

In the CMBS market, we believe there are attractive risk-adjusted investment opportunities available amid an improving fundamental backdrop. In our view, borrowers with access to capital will continue to make investments in properties that were performing well before the pandemic hampered their revenue streams.

Near-term inflation expectations are significantly higher than they were prior to the pandemic. We think commercial properties can better absorb inflation pressures compared with other market sectors, such as corporate credit. Consequently, if inflation rises, we believe areas of the CMBS market may offer compelling relative-value opportunities.

Within residential mortgage credit, given low mortgage rates, high demand, and a declining inventory of available homes, we think home prices are likely to continue rising. Even with tighter yield spreads, we have continued to find value in investment-grade securities backed by non-agency residential loans, along with legacy residential mortgage-backed securities and lower-quality segments of the agency credit-risk transfer market.

We believe prepayment-sensitive areas of the market serve as important sources of diversification for the fund. To us, the prepayment sector offers potential benefits in the event of an economic slowdown, changes in fiscal policy, and/or rising interest rates. In our view, many prepayment-sensitive investments offer attractive risk-adjusted return potential at current price levels. In terms of investment selection, we are focused on securities backed by reverse mortgages, jumbo loans, and more seasoned collateral.

Putnam Income Fund (PNCYX)

Annualized total return performance as of 6/30/21

	Class Y shares Inception 6/16/94	**Bloomberg Barclays U.S. Aggregate Bond Index**
Last quarter	0.14%	1.83%
1 year	1.41	–0.33
3 years	5.34	5.34
5 years	4.66	3.03
10 years	4.27	3.39
Life of fund	7.42	—

Total expense ratio: 0.60%

What you pay: 0.48%

Source: Bloomberg Index Services Limited.

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 June 30, 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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