

Q4 2019 | Putnam Income Fund Q&amp;A

# Mortgage credit helps fund outperform



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*The fund generated a modest gain for the quarter and outperformed the broad investment-grade fixed-income market.*

*Synthetic exposure to commercial mortgage-backed securities and favorable interest-rate/yield-curve positioning drove the fund's relative performance. Conversely, adverse prepayment positioning and underweight exposure to corporate credit dampened results.*

*We believe the risk of recession has diminished globally, primarily due to accommodative monetary policies by many central banks.*

## How did the fund perform for the three months ended December 31, 2019?

The fund's class Y shares gained 0.77%, outpacing the benchmark Bloomberg Barclays U.S. Aggregate Bond Index.

## Which holdings and strategies aided the fund's relative performance?

Our mortgage-credit positions accounted for the bulk of the fund's outperformance, led by our synthetic exposure to commercial mortgage-backed securities [CMBS] via CMBX. CMBX is an index that references a basket of CMBS issued in a particular year. The fund's allocation to CMBX tranches rated BBB and A added the most value.

The fund's interest-rate and yield-curve positioning also aided results, albeit to a lesser degree. The portfolio's duration was modestly shorter than that of the benchmark. This positioning helped performance as yields trended moderately higher during the quarter. Also, positioning the portfolio for a steeper yield curve provided a further boost. Longer-term yields rose while shorter-term rates were generally stable, anchored by Fed interest-rate cuts.

## What detracted from performance?

Within strategies targeting prepayment risk, our "mortgage basis" positioning worked against results. Mortgage basis is a strategy that seeks to exploit the yield differential between 30-year agency pass-throughs and 30-year U.S. Treasuries.

An underweight allocation in investment-grade corporate credit also dampened relative performance. The asset class rallied in November, following an October rate cut by the U.S. Federal Reserve [Fed] and optimism about a phase-one trade deal with China. For the quarter as a whole, investment-grade credit spreads tightened, as bond prices rose.

### **What is your near-term outlook?**

We believe the risk of recession has diminished globally, primarily due to the response from many central banks. The Fed reduced its target for short-term interest rates three times in 2019. In September, the European Central bank trimmed interest rates for the first time since 2016. It also re-started a bond-buying program designed to inject liquidity into eurozone economies. The Bank of Japan hinted that it was willing to cut interest rates further into negative territory as part of a new effort to achieve a target inflation rate of 2%. And, right after the new year began, the People's Bank of China said it would further loosen monetary policy by reducing the amount of reserves banks need to keep on hold at the central bank, essentially freeing up cash for lending.

The United States and China are the two biggest drivers of global growth. Late in the quarter, President Trump said that he would sign the recently negotiated phase-one trade deal with China in January. This announcement marked a formal truce in the trade war between the two countries. The president also stated that he would travel to Beijing at a later date to negotiate a broader pact. Overall, we think these developments represent a substantial improvement in the tone of trade discussions between the two countries.

When the Fed shifted back to a more accommodative monetary policy stance early in 2019, the U.S. housing market responded positively. In October, home prices rose 3.3% on an annual basis, according to the S&P CoreLogic Case-Shiller U.S. National Home Price Index, which measures average home prices in major metropolitan areas across the United States. This growth rate was marginally greater than the 3.2% year-over-year rise in September. Against the backdrop of mortgage rates that are low by historical standards, we think home price growth suggests that the economy is likely to continue expanding at a steady, moderate pace.

Within this environment, we think intermediate- and long-term bond yields are likely to drift somewhat higher. Also, Fed officials have indicated comfort with leaving monetary policy on hold through 2020, while keeping an eye on economic and trade-related risks. As a result, we don't expect short-term interest rates to move significantly over the near term. Consequently, we believe the yield curve is likely to steepen.

### **What is your assessment of the various areas of the market in which the fund invests?**

We continue to have a generally favorable outlook for mortgage credit. We think the underlying fundamentals for commercial real estate appear stable, supported by a strong employment backdrop, interest rates that remain historically low, and a positive U.S. economic environment.

We continue to find better relative value in CMBX versus cash bonds. We think the negative sentiment toward the retail industry — though well deserved — overstates the risk of the index. We think the index offers sufficient protection, even at the BBB-rated level. In our view, mall operators may be able to stabilize their revenues by repurposing properties, thereby mitigating or delaying losses.

Within cash CMBS, we have been focusing on mezzanine tranches rated A and BBB- that were issued between 2011 and 2014. Securities in this market category offered an attractive, risk-adjusted yield premium over many other areas. We have been avoiding mezzanine securities issued in 2015 or later.

Concerning corporate credit, we continue to like the BBB-rated market segment. For several years, debt issuance increased as corporations financed mergers and acquisitions. Now, we're beginning to see BBB issuers reduce debt. In high-yield credit, areas that have underperformed — such as lower-rated issuers in energy and other sectors — could rebound if economic growth remains steady and stocks continue to advance. Overall, we believe continued moderate economic growth should support growth in earnings and cash flow for corporate issuers.

Within agency credit-risk transfer [CRT] securities, an improving fundamental and supply/demand backdrop for housing has tempered our view of downside risk. We continue to like the relative stability of securities that have a few years of seasoning versus newly issued CRT. That said, we are also seeing increased value in newer CRT deals. We continue to find value among legacy residential mortgage-backed securities, where we think a steadily shrinking market and stable investor base provide a supportive technical backdrop.

Within prepayment-sensitive areas of the market, declining Treasury yields during most of 2019 triggered concern about the potential for increased refinancing. However, prepayment speeds for newer loans have thus far stayed within the market’s range of expectations. Given the relative lack of value in newer loans, we’ve focused on opportunities in certain subsectors that we believe can dampen prepayment volatility and create value. We are focusing our selection efforts on securities backed by reverse mortgages, jumbo loan balances, and seasoned collateral. We also like opportunities among loans backed by the Housing Finance Administration.

**Putnam Income Fund (PNCYX)**

Annualized total return performance as of 12/31/19

<b>Class Y shares</b> Inception 6/16/94	<b>Net asset value</b>	<b>Bloomberg Barclays U.S. Aggregate Bond Index</b>
Last quarter	0.77%	0.18%
1 year	11.68	8.72
3 years	6.04	4.03
5 years	3.73	3.05
10 years	5.13	3.75
Life of fund	7.52	—

Total expense ratio: 0.63%

What you pay: 0.49%

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 2/28/21.

*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.

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, 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, 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. You can lose money by investing in the fund.

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