Q4 2020 | Putnam Income Fund Q&A

Mortgage credit drives performance

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

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

Emily E. Shanks
Portfolio Manager
Industry since 1999

Risk assets performed well for most of the quarter amid consistent investor demand.

Mortgage holdings exposed to credit risk fueled the fund's outperformance of the benchmark. Conversely, underweight exposure to investment-grade corporate bonds detracted.

Continuing recovery in the U.S. economy and the rollout of COVID-19 vaccines has sparked investor optimism entering 2021.

Not FDIC insured | May lose value | No bank guarantee

How did the fund perform for the three months ended December 31, 2020?

The fund's class Y shares gained 2.37%, outpacing the 0.67% return of the benchmark Bloomberg Barclays U.S. Aggregate Bond Index.

What was the market environment like during the fourth quarter of 2020?

Markets closed on a strong note to finish a most unusual year. News of multiple COVID-19 vaccines fueled hopes of returning to more normalcy in the economy, markets, and society as we move through 2021. Credit performed well with spreads tightening across the quality spectrum. [Bond prices rise as spreads tighten and fall as spreads widen.] Yields on longer-term U.S. Treasuries rose during the quarter, muting returns of indexes with a heavier government weighting, including the fund's benchmark. Within this environment, investment-grade corporate bonds outpaced the broad investment-grade fixed-income market, but trailed high-yield corporate credit.

Although Treasury yields rose during the final three months of 2020, they remained below where they began the year. For example, the yield on the benchmark 10-year U.S. Treasury rose 0.22% to end 2020 at 0.91% after beginning the year at 1.92%.

Which holdings and strategies fueled the fund's outperformance of the benchmark?

Mortgage credit holdings contributed the most on a relative basis, led by our exposure to commercial mortgage-backed securities [CMBS]. December marked the fifth straight month that credit-driven mortgage securities aided the fund following a pullback in July.

Within CMBS, synthetic exposure via CMBX added the most value. [CMBX is a group of tradeable indexes that each reference a basket of 25 CMBS issued in a particular year.] There continues to be a degree of negative sentiment toward certain property types, most notably hotels and malls, which are highly sensitive to short-term occupancy trends. At the same time, however, the availability of COVID-19 vaccines has sparked optimism about the ultimate duration of social-distancing measures.

Positions in agency credit-risk transfer [CRT] securities also aided the fund's performance. A variety of factors helped agency CRT, including housing-related government policy measures in response to COVID-19, housing market strength, and optimism about the re-opening of the economy. CRT also benefited from a growing borrower base capitalizing on lower mortgage interest rates and improved home affordability.

Strategies targeting prepayment risk provided a further boost to fund performance, 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 during the second half of 2020 [meaning their prices rose relative to Treasuries]. Our mortgage-basis positioning also helped to offset the generally negative impact of faster prepayment speeds on other holdings in this part of the portfolio.

Holdings of inverse interest-only [IO] securities also contributed. Prepayment speeds on the mortgages underlying these securities stabilized after rising during the summer. This gave investors greater confidence in their ability to build models that anticipate speeds going forward, even if they remain at higher levels. [Mortgage refinancing and early repayment of outstanding mortgages drives prepayment speeds.]

What about detractors?

A lower-than-benchmark allocation in investment-grade corporate credit modestly dampened relative performance as spreads tightened and bond prices rose.

What is your near-term outlook?

Across asset classes, market participants ended 2020 with significant optimism for 2021. Investors will remain focused on vaccine rollouts, corporate earnings, and any change in stance from the U.S. Federal Reserve [Fed] to see if that optimism remains justified as we head through 2021. We think the potential for additional fiscal stimulus has also brightened investors' moods.

How was the fund positioned as of December 31?

We think measures by the Fed and other central banks to shore up marketplace liquidity amid the COVID-19 crisis may keep U.S. interest rates range bound for an extended period of time. As a result, we plan to keep the fund's duration relatively close to that of its benchmark. In our view, having a duration greater than the benchmark [greater interest-rate sensitivity] in the current environment is not an effective hedge against credit risk within the portfolio.

We have a relatively positive medium-term outlook for corporate credit. While acknowledging the ongoing risks associated with COVID-19, we believe there are factors that will be supportive for the U.S. corporate credit market. These include demand for comparatively higher yields in the face of much lower yields globally. Also, investors are aware that the Fed is prepared to provide further support to the market via its bond purchase facilities if necessary.

Within the CMBS market, we believe borrowers with access to capital will continue to make investments in properties that were performing well before the pandemic hampered their revenue streams. As a result, we continue to have conviction in the fund's CMBX exposure. 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, we believe the dislocations that occurred in March have been mitigated by U.S. monetary and fiscal policy and the gradual reopening of the economy. Against the backdrop of robust home sales and a rebound in mortgage originations, we continue to find value across numerous segments of the residential mortgage-backed market.

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

Putnam Income Fund (PNCYX)

Annualized total return performance as of 12/31/20

Class Y shares Inception 6/16/94	**Net asset value**	**Bloomberg Barclays U.S. Aggregate Bond Index**
Last quarter	2.37%	0.67%
1 year	7.19	7.51
3 years	6.41	5.34
5 years	5.50	4.44
10 years	4.96	3.84
Life of fund	7.51	—

Total expense ratio: 0.60%

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, 2020, 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.

A world of investing.®

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.

Putnam Retail Management

Putnam Investments | 100 Federal Street | Boston, MA 02110 | putnam.com

TL035 324047 1/21