

Q2 2020 | Putnam Income Fund Q&A

Prepayment risk boosts fund amid market recovery



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Risk assets rebounded sharply in the wake of March's market upheaval.

Strategies targeting prepayment risk fueled the fund's outperformance of the benchmark. On the downside, exposure to commercial mortgage-backed securities detracted.

As the second half of 2020 begins, investors will focus on economic data, corporate earnings, and signs of progress toward a coronavirus vaccine.

How did the fund perform for the three months ended June 30, 2020?

The fund's class Y shares returned 4.30%, outpacing the 2.90% gain of the benchmark Bloomberg Barclays U.S. Aggregate Bond Index.

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

There was a massive reversal in both market sentiment and price levels across asset classes during the quarter. Fiscal and monetary stimulus, along with hopes of a sharp economic recovery, fueled the snapback. The U.S. Federal Reserve [Fed] began implementing a series of lending programs by making asset purchases across a variety of market sectors.

Against this backdrop, investment-grade corporate bonds (Bloomberg Barclays U.S. Corporate Index) and high-yield credit (JPMorgan Developed High Yield Index) advanced 9% and 9.7%, respectively, as investors reembraced risk. Accordingly, more defensive areas of the market lagged, including U.S. government securities and agency mortgage-backed bonds. Interest rates were rangebound throughout the quarter, with the yield on the benchmark 10-year U.S. Treasury note staying below 1%.

In April, oil prices briefly dipped into negative territory before rising on further supply cuts and hopes that demand will increase as the economy reopens. While the energy sector has been one of the biggest laggards for the year to date through June, it was by far the best-performing group in the second quarter. Other sectors that were negatively impacted by the coronavirus also recovered, except for airlines, which continued to struggle amid reduced demand for air travel.

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

Strategies targeting prepayment risk added the most relative value this quarter, particularly our holdings of inverse interest-only [IO] securities. As new issuance resumed following March's market upheaval, inverse IOs benefited from improving supply-and-demand dynamics.

Tactical mortgage basis positioning also aided our prepayment strategies. Mortgage basis is a strategy that seeks to exploit the yield differential between 30-year agency pass-throughs and 30-year U.S. Treasuries.

Our corporate credit holdings — primarily investment-grade — moderately contributed to relative performance. Following a sizable widening of yield spreads in March, spreads tightened during the quarter. [Spreads are the yield advantage credit-sensitive bonds offer over comparable-maturity U.S. Treasuries. Bond prices rise as spreads tighten and decline as spreads widen.] Unprecedented stimulus measures implemented by government policymakers boosted investor confidence by helping to offset some of the near-term economic uncertainty sparked by the coronavirus pandemic.

What about detractors?

Within our mortgage credit holdings, synthetic exposure to commercial mortgage-backed securities [CMBS] via CMBX was the primary detractor versus the benchmark. [CMBX includes a group of tradeable indexes that reference a basket of 25 CMBS deals issued in a particular year.] In a continuation from March, investors worried that the pandemic could severely impact cash flows in various segments of the commercial real estate market, particularly retail and lodging. Public health policies that curtailed shopping and travel for millions of people constrained the revenues for many malls and travel destinations.

The Fed's announcement that AAA-rated CMBS would be included in its Term Asset-Backed Loan Facility [TALF], along with renewed demand for risk, helped the sector rebound in June. However, this boost was not enough to fully offset earlier losses. TALF is a reprise of a program launched in 2009 that enabled investors to buy bonds linked to consumer and business debt using money borrowed from the Fed.

What is your near-term outlook?

As the quarter came to a close, coronavirus cases began to reaccelerate, particularly in areas of the country that were the first to open. As a result, plans to fully reopen certain parts of the economy, such as restaurants and bars, have been put on hold in the affected areas.

Amid stronger-than-expected economic reports, investors seem to be shrugging off the increase in infection rates, at least for now. As we begin the second half of 2020, it is likely that the coronavirus will continue to dominate the news. Investors, meanwhile, will remain focused on economic data, indications of progress toward a vaccine, and the impact of second-quarter earnings on corporate balance sheets.

How was the fund positioned as of June 30?

During the past few months, the portfolio's duration versus the benchmark's has been neutral to moderately shorter. As of June 30, the fund's duration was close to the benchmark's at 5.5 years. The portfolio was positioned to benefit if the yield curve remains relatively steep or steepens further.

Within corporate credit, the fund was modestly underweight investment-grade debt. Our emphasis here continues to be on security selection.

COVID-19 created significant headwinds for the CMBS market because commercial real estate is in the "eye of the storm." Uncertainty about the duration of social distancing measures makes for a challenging backdrop, particularly for hotel and retail properties, which have only recently begun reopening.

We believe most properties that were functioning well prior to the crisis and have reasonable levels of equity will survive, buoyed by government support, operator reserves, and/or debt-service modifications.

We continue to have conviction in the fund's CMBX positions, which we believe offer value at the single A and BBB levels for indexes representing 2012–2014 issuance. In addition, we think the relatively large sell-off in newer vintages has presented additional value in that part of the market.

In our view, prepayment-sensitive areas of the market directly benefit when there are increased frictions in the housing finance industry. Given the potential for a deepening of the recession, there are ongoing risks related to high unemployment, weaker projected home-price appreciation, lower home turnover, and reduced homeowner mobility. Even as the use of mortgage forbearance grows, cash flows to investors from agency mortgages are guaranteed by government-sponsored enterprises. As a result, we continue to have confidence in the fund's holdings of interest-only collateralized mortgage obligations and inverse IOs backed by more seasoned collateral.

Putnam Income Fund (PNCYX)

Annualized total return performance as of 6/30/20

Class Y shares Inception 6/16/94	Net asset value	Bloomberg Barclays U.S. Aggregate Bond Index
Last quarter	4.30%	2.90%
1 year	7.15	8.74
3 years	5.87	5.32
5 years	4.27	4.30
10 years	4.80	3.82
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.

The Bloomberg Barclays U.S. Corporate Bond Index measures the investment-grade, fixed-rate, taxable corporate bond market.

The JPMorgan Developed High Yield Index is an unmanaged index of high-yield fixed-income securities issued in developed countries.

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, 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.

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