

## Q3 2020 | Putnam Income Fund Q&amp;A

# Prepayment risk boosts performance



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

***Strategies targeting prepayment risk fueled the fund's outperformance of the benchmark. On the downside, underweight exposure to investment-grade corporate bonds detracted.***

***While recent data have shown recovery in key sectors of the economy, we believe it will take an extended period to fully overcome the damage caused by the pandemic.***

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

The fund's class Y shares returned 1.26%, outpacing the 0.62% gain of the benchmark Bloomberg Barclays U.S. Aggregate Bond Index.

## What was the market environment like during the third quarter of 2020?

Risk assets broadly gained in July and August, though a surge in COVID-19 infection rates, mixed economic data, and heightened geopolitical tensions stoked increased volatility. Positive earnings reports from several sectors, vaccine developments, and supportive policy — including a historic stimulus package passed by the European Union — generally supported risk appetites. A shift in the U.S. Federal Reserve's inflation framework — which would enable the Fed to allow inflation to exceed its 2% target and further support the economy — helped contribute to investor optimism.

Risk assets pulled back moderately in September, partly due to increased global economic concerns stemming from an upsurge in virus cases in Europe. Fading hope for another U.S. stimulus package and uncertainty surrounding upcoming U.S. elections also weighed on investor sentiment.

Credit spreads tightened during the quarter. Meanwhile, interest rates were range bound, with the yield on the benchmark 10-year U.S. Treasury note finishing the quarter at 0.68%, close to where it began.

Reflecting investor demand for risk, investment-grade corporate bonds outpaced the broad investment-grade fixed-income market, but trailed high-yield corporate credit. Accordingly, more defensive areas of the market lagged, including U.S. government securities and agency mortgage-backed bonds.

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

Strategies targeting prepayment risk added the most relative value this quarter, led by our mortgage basis positioning. Mortgage basis is a strategy that seeks to exploit the yield differential between 30-year agency pass-throughs and 30-year U.S. Treasuries. The strategy added value as spreads on agency pass-throughs tightened throughout the quarter [meaning their prices rose relative to Treasuries].

Holdings of inverse interest-only [IO] securities also contributed. Prepayment speeds on the mortgages underlying these securities stabilized after rising somewhat early in the summer. Mortgage refinancing and early repayment of outstanding mortgages drive prepayment speeds.

Mortgage credit holdings also notably contributed versus the benchmark, in particular, positions in agency credit-risk transfer securities [CRT]. Allocations to commercial mortgage-backed securities [CMBS] — both IOs and cash bonds — were further contributors, aided by improving supply-and-demand dynamics.

### **What about detractors?**

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

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

Recent data have shown recovery in key sectors of the U.S. economy, including manufacturing, housing, and consumer spending. However, the service sector continues to be constrained by the limitations resulting from the pandemic. We expect this trend to continue until a vaccine becomes widely available.

We are not anticipating a V-shaped economic recovery. While we expect intervals of rapid growth, we believe it will take an extended period of time for the economy to fully recover from the damage done by the mobility restrictions spawned by the pandemic. Also, renewed virus outbreaks are likely to constrain the service sector and limit growth.

### **How was the fund positioned as of September 30?**

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 portfolio 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 risks mentioned above, 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 know that the Fed is prepared to provide further support to the market via its bond purchase facilities if necessary. So far, the central bank has invested only a small portion of the \$750 billion earmarked for corporate debt purchases. However, knowing that the Fed stands ready to step in if needed has provided an important boost to market sentiment. As of quarter-end, 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 due to the negative impact on commercial real estate. That said, during the quarter, we began to see some improvement in higher-rated cash bonds. We continue to have conviction in the fund's CMBX positions, which we believe fairly compensate investors for current risk levels. [CMBX includes a group of tradeable indexes that reference a basket of 25 CMBS issued in a particular year.]

Within residential mortgage credit, we believe the agency CRT sector directly benefits from the efforts of the federal government, as well as government-sponsored enterprises such as Fannie Mae and Freddie Mac, to keep people in their homes. We also believe the dislocations that occurred in March have been mitigated by U.S. monetary and fiscal policy and the gradual reopening of the economy. Consequently, we continue to find value in various segments of the CRT market as well as in the non-agency residential mortgage-backed market.

In prepayment-sensitive areas of the market, despite a recent increase in refinancing activity leading to faster prepayment speeds on underlying securities, we continue to find value in agency interest-only collateralized mortgage obligations and inverse IOs backed by more seasoned collateral. We also believe IO securities structured from reverse mortgages continue to offer value.

**Putnam Income Fund (PNCYX)**

Annualized total return performance as of 9/30/20

<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	1.26%	0.62%
1 year	5.51	6.98
3 years	5.99	5.24
5 years	4.91	4.18
10 years	4.65	3.64
Life of fund	7.50	—

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 September 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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