Q3 2018 | Putnam Dynamic Asset Allocation Funds Q&A

# U.S. stocks lift funds despite impact of rising rates on bonds

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***U.S. stocks gained during the third quarter on economic expansion.***

***Bond yields in the United States and globally will likely continue to rise.***

***The Federal Reserve's rate increases may pressure U.S. equity markets.***



**What was the equity market environment during the third quarter?**

Stock markets around the world advanced during the third quarter following several months of volatility from trade conflicts and geopolitical concerns. Steady global growth and corporate earnings remained a positive backdrop for equity markets. However, a more hawkish-sounding U.S. Federal Reserve, trade-war jitters, and global political risks dampened gains in international and U.S. equities during the quarter. The United States and China, the world's two largest economies, launched new trade tariffs and tensions escalated.

U.S. stocks posted strong quarterly gains as all three major indexes recorded their best quarterly performance in five years. Both the Dow Jones Industrial Average and the S&P 500 Index have now advanced in 11 of the past 12 quarters, and the Nasdaq marked its ninth consecutive quarterly gain. Stocks were lifted by strong economic growth and positive corporate earnings. The broad S&P 500 rose 7.7%, and the Dow gained 9.6%. International stocks as measured by the MSCI EAFE Index [ND] returned 1.35% for the quarter.

The U.S. economy remained healthy. The economy added more jobs than expected in August 2018, and wages grew at the fastest pace since 2009. Real GDP increased at an annual rate of 4.2% in the second quarter, its best performance in nearly four years, and a gauge of consumer sentiment also reached new highs. Still, trade policy caused some pullbacks in the markets as the United States added tariffs to $200 billion in Chinese goods.

The dollar surged after the Fed raised rates in September for the third time this year, and signaled that it is on track to hike one more time in 2018. The September increase takes the federal funds rate to a range of 2% to 2.25%, and it is the eighth increase since the Fed began normalizing policy in December 2015. Across the Atlantic Ocean, the European Central Bank [ECB] confirmed that it will cut bond-buying in half in October 2018 and anticipates that new purchases will be halted by the end of the year.

### How did bond markets perform?

Short-term interest rates continued to increase steadily during the quarter. The yield on the two-year U.S. Treasury bill traded above 2.8%, and the benchmark 10-year Treasury yield rose steadily to above the psychologically important 3% level in the final two weeks of the quarter. As mentioned, the Fed raised short-term rates at the end of September, the third hike this year, and officials have penciled in another hike by the end of the year. U.S. economic strength, including a tightening labor market and an improving outlook for wage gains, also drove bond yields higher. High-yield bonds gained during the period, and spreads remained tight due to steady risk appetite from investors, though emerging-market debt came under pressure due to higher U.S. rates and a strong dollar. The Bloomberg Barclays U.S. Aggregate Bond Index was little changed during the quarter.

### How did Putnam Dynamic Asset Allocation Funds perform?

The three Dynamic Asset Allocation Funds reported positive returns during the quarter. Our fund strategies returned positive results in July, August, and September, and all three funds performed in line with their internal custom benchmarks. The Conservative Fund's more fixed-income-centric investments delivered a return of 2.02%, while the more equity-centric Growth Fund and Balanced Fund returned 4.35% and 3.86%, respectively.

### What strategies contributed to performance?

Our asset allocation strategies during the quarter were, in aggregate, roughly flat, reflecting our close-to-benchmark allocations. We maintained a slightly overweight tactical position in equities relative to benchmark allocations and held an out-of-benchmark position in commodities. Those positions were net positive contributors owing to the strength in equity markets and the rally in oil prices. Our slightly underweight position in high-yield fixed-income securities was a small detractor.

Security selection was also roughly flat during the period, but there were meaningful contributors and detractors within strategies. Our U.S. large-cap stocks outperformed the broad market, helping to erase some of the losses in the year-to-date period. Our international developed-market equities also outperformed. Emerging-market stock selection, affecting only the Growth Fund, was a detractor, as was our currency overlay strategy.

### What is the outlook for the fourth quarter of 2018?

This year is turning out to be more mixed than 2017. Global growth prospects are expected to remain relatively stable in 2018. The U.S. economy is poised to expand further this year given indicators for consumer spending, corporate investment, and government fiscal stimulus. The labor market remains strong as Americans saw wage gains accelerate and hiring improve. Meanwhile, U.S. inflation remains benign. However, concerns about an escalation in the trade wars between the United States and other major economies continue to plague markets around the world.

Despite strong underlying fundamentals, stocks may be affected by continued trade tensions, the trajectory of U.S. interest rates, and geopolitical risks. At the September 2018 rate meeting, the Fed raised its projection for economic growth this year and next, and provided a road map of what lies ahead through 2021. Along with the rate increase, the FOMC continued to project one more hike before the end of the year and three in 2019. The federal funds rate serves as the baseline for multiple forms of consumer debt as well as savings accounts and CD rates.

In terms of our investment strategies, we recently reduced our equities exposure to neutral. We are concerned that the markets are shrugging off risks from trade policies and tariffs. In addition, companies are operating at near peak margins and the bar may be too high for 2019 company earnings. In credit, while fundamentals appear fair, high-yield bond spreads remain near 2018 tights, skewing potential outcomes to the negative. For commodities, we are maintaining a slightly bullish outlook for the asset class as a whole although we have reduced our exposure from earlier in the year.

We expect bond yields in the United States and globally to continue rising over the next few years. However, we will increase our exposure over the short term if we believe that U.S. rates are rising too quickly. There is potential for Fed rate hikes to pressure risky assets, specifically U.S. equities, and drive people to the safety of Treasuries. Bond yields may also dip and prices rise if the weakness in emerging-market assets prompts investors to reduce their appetite for riskier assets or if U.S. economic data are weaker than anticipated.

## Putnam Dynamic Asset Allocation Balanced Fund (PABYX)

Annualized total return performance as of 9/30/18

| **Class Y shares** Inception 7/5/94 | **Net asset value** | **Russell 3000 Index** | **Putnam Balanced Blended Benchmark** |
|---|---|---|---|
| Last quarter | 3.86% | 7.12% | 3.80% |
| 1 year | 8.18 | 17.58 | 8.57 |
| 3 years | 9.80 | 17.07 | 10.26 |
| 5 years | 8.62 | 13.46 | 8.24 |
| 10 years | 9.22 | 12.01 | 8.61 |
| Life of fund | 7.47 | 9.81 | — |

Total expense ratio: 0.74%

Class A share inception: 2/7/94

## Putnam Dynamic Asset Allocation Conservative Fund (PACYX)

Annualized total return performance as of 9/30/18

| **Class Y shares** Inception 7/14/94 | **Net asset value** | **Bloomberg Barclays U.S. Aggregate Bond Index** | **Putnam Conservative Blended Benchmark** |
|---|---|---|---|
| Last quarter | 2.02% | 0.02% | 1.96% |
| 1 year | 3.39 | -1.22 | 3.71 |
| 3 years | 5.67 | 1.31 | 5.92 |
| 5 years | 5.69 | 2.16 | 5.30 |
| 10 years | 6.99 | 3.77 | 6.43 |
| Life of fund | 6.09 | 5.08 | — |

Total expense ratio: 0.77%

Class A share inception: 2/7/94

## Putnam Dynamic Asset Allocation Growth Fund (PAGYX)

Annualized total return performance as of 9/30/18

| **Class Y shares** Inception 7/14/94 | **Net asset value** | **Russell 3000 Index** | **Putnam Growth Blended Benchmark** |
|---|---|---|---|
| Last quarter | 4.35% | 7.12% | 4.54% |
| 1 year | 10.14 | 17.58 | 10.74 |
| 3 years | 12.35 | 17.07 | 12.88 |
| 5 years | 9.99 | 13.46 | 9.59 |
| 10 years | 9.98 | 12.01 | 9.56 |
| Life of fund | 8.24 | 9.81 | — |

Total expense ratio: 0.84%

Class A share inception: 2/8/94

Returns for periods of less than one year are not annualized.

*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, which have not been adjusted for the lower expenses; had they, returns would have been higher. For a portion of the periods, these funds 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 funds' benchmarks are administered by Putnam Investments and have the following compositions: For Putnam Conservative Blended Benchmark, 65% Bloomberg Barclays U.S. Aggregate Bond Index, 25% Russell 3000 Index, 5% JPMorgan Developed High Yield Index, and 5% MSCI EAFE Index (ND); for Putnam Balanced Blended Benchmark, 50% Russell 3000 Index, 35% Bloomberg Barclays U.S. Aggregate Bond Index, 10% MSCI EAFE Index (ND), and 5% JPMorgan Developed High Yield Index; and for Putnam Growth Blended Benchmark, 60% Russell 3000 Index, 15% MSCI EAFE Index (ND), 15% Bloomberg Barclays U.S. Aggregate Bond Index, 5% JPMorgan Developed High Yield Index, and 5% MSCI Emerging Markets Index (¢). The Bloomberg Barclays U.S. Aggregate Bond Index is an unmanaged index of U.S. investment-grade fixed-income securities. The JPMorgan Developed High Yield Index is an unmanaged index of high-yield fixed-income securities issued in developed countries. The MSCI EAFE Index (ND) is an unmanaged index of equity securities from developed countries in Western Europe, the Far East, and Australasia. The MSCI Emerging Markets Index (GD) is a free float-adjusted market capitalization index that is designed to measure equity market performance in the global emerging markets. The Russell 3000 Index is an unmanaged index of the 3,000 largest U.S. companies. Securities in the funds do not match those in the indexes, and performance of the funds will differ. It is not possible to invest directly in an index.

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**Consider these risks before investing:** Allocation of assets among asset classes may hurt performance. Stock and bond prices may fall or fail to rise over time for several reasons, including general financial market conditions, factors related to a specific issuer or industry and, with respect to bond prices, changing market perceptions of the risk of default and changes in government intervention. These factors may also lead to increased volatility and reduced liquidity in the bond markets. International investing involves currency, economic, and political risks. Emerging-market securities carry illiquidity and volatility risks. Investments in small and/or midsize companies increase the risk of greater price fluctuations. Growth stocks may be more susceptible to earnings disappointments, and value stocks may fail to rebound. 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). Default risk is generally higher for non-qualified mortgages. Interest-rate risk is greater for longer-term bonds, and credit risk is greater for below-investment-grade bonds. Unlike bonds, funds that invest in bonds have fees and expenses. The use of derivatives may increase these risks by increasing investment exposure (which may be considered leverage) or, in the case of over-the-counter instruments, because of the potential inability to terminate or sell derivatives positions and the potential failure of the other party to the instrument to meet its obligations. You can lose money by investing in the funds.

Diversification does not guarantee a profit or ensure against loss. It is possible to lose money in a diversified portfolio.

The S&P 500 Index is an unmanaged index of common stock performance.

The Dow Jones Industrial Average Index (DJIA) is an unmanaged index composed of 30 blue-chip stocks whose one binding similarity is their hugeness — each has sales per year that exceed $7 billion. The DJIA has been price-weighted since its inception on May 26, 1896, reflects large-cap companies representative of U.S. industry, and historically has moved in tandem with other major market indexes such as the S&P 500.

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