Q4 2018 | Putnam Dynamic Asset Allocation Funds Q&A

Stocks tumble on rising interest rates and uncertain economic outlook

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Global stocks slumped during the fourth quarter as investors hit the sell button.

Bond yields in the United States and around the world could continue to rise.

Further Federal Reserve rate increases may pressure U.S. equity markets.

What was the equity market environment during the fourth quarter?

The period was fraught with volatility. Markets started the quarter near record highs before a sharp reversal. By the end of December, U.S. and many international stock markets posted their worst yearly results since the 2008 financial crisis. The U.S. economy remained strong but interest rates, market volatility, and global trade tensions increased. Buoyed by tax cuts, the U.S. economy grew at a 3.5% annual rate in the third quarter of 2018, after expanding 4.2% in the second quarter. Unemployment has touched multi-decade lows, inflation remains anchored, and the likelihood of a recession remains low.

Still, the outlook for global economic growth has eased over the past few months because of protectionist tariffs, higher interest rates, and weakness in many emerging markets, including China. Trade tensions between the United States and China, the world's two largest economies, escalated at the beginning of the fourth quarter. However, by December 2018, Chinese and U.S. negotiators were starting to work toward a deal that could defuse trade tensions by boosting U.S. exports and loosening regulations for U.S. companies operating in China.

Large-cap stocks and their mid- and small-cap counterparts declined as market volatility and losses spiked in October and again in December 2018. The broad S&P 500 Index fell to the brink of a bear market in December. It ended 2018 down 4.4%. For the quarter, the S&P 500 declined 13.5%. International stocks as measured by the MSCI EAFE Index [ND] dropped 12.5%.

The Federal Reserve raised its benchmark interest rate in December for the fourth time in 2018. The rate hike took the federal funds rate to a range of 2.25% to 2.5%. It was the ninth increase since the Fed began normalizing policy in December 2015. Across the Atlantic, the European Central Bank [ECB] said it was ending its multi-trillion bond-buying program in December. The ECB also left benchmark interest rates unchanged.

How did bond markets perform?

Treasury yields moved higher on the short end of the yield curve and lower on the intermediate and long end. The widely watched spread between two- and 10-year Treasury yields narrowed to less than 10 basis points following the Fed's rate boost in December. The decline in long-term yields is a sign that bond investors expect the economy to slow. Also, higher short-term rates are a headwind for fixed-income asset holders. The yield on the benchmark 10-year note ended at 2.66%, while the two-year yield held at around 2.50% at year-end 2018. High-yield bonds were negative for the period, with the risk-off sentiment pushing spreads wider. The more rate-sensitive Bloomberg Barclays U.S. Aggregate Bond Index rose 1.6% during the quarter, benefiting from the move lower in intermediate- and long-term yields.

How did Putnam Dynamic Asset Allocation Funds perform?

The three Dynamic Asset Allocation Funds had negative returns during the quarter, reflecting the market weakness of October and December. The Conservative Fund, with its more fixed-income-centric investments, declined 5.3%. The more equity-centric Balanced Fund and Growth Fund fell 10.3% and 13.3%, respectively.

What strategies affected performance?

The funds' negative performance resulted from exposure to equities, bonds, and inflation-sensitive assets. Stocks and commodities were the biggest decliners. We took a tactical overweight position in U.S. equities after the moderate market correction in October. This position later detracted from fund performance as stocks slumped from mid-year highs. Our out-of-benchmark commodities position also detracted. The commodities sector struggled during the dramatic sell-off in crude oil prices. This occurred when the U.S. government granted waivers from sanctions to some of the biggest buyers of oil exports from Iran.

Our active implementation decisions and security selections also detracted during the quarter. They were driven by our quantitative strategies in U.S. large-cap and international developed equity markets. Our team analyzes stock market history to identify characteristics of stocks (factors) that have excess risk-adjusted returns. Despite a strong long-term relationship between these factors and positive stock performance, the strategies underperformed during the quarter.

What is the outlook for the first quarter of 2019?

Economic growth in the United States is likely to slow in the first half of 2019. The fast pace set during the second and third quarters of 2018 is decelerating as the impact of the year-end 2017 corporate tax cut fades. Fed Chair Jerome H. Powell in December acknowledged the economy is showing signs of "softening." In January, he said that low inflation would allow the Fed to be "patient" in deciding whether to continue raising interest rates. Overall, the combination of a peak in global growth momentum, mounting trade risks, and a more restrictive Fed is a good recipe for higher volatility in markets.

Although stock and bond market volatility is likely to persist in 2019, we recently increased our exposure to equity, inflation (commodities), and credit risks, looking to take advantage of short-term market weakness. We expect bond yields to continue to drift higher in 2019 as interest-rate normalization continues in the United States and globally. The Fed has been reducing its balance sheet, allowing up to $30 billion of Treasuries and $20 billion of mortgages that it holds to mature without re-investing the proceeds.

The portfolios have an overweight in U.S. equities and commodities. We are neutral on high-yield credit and slightly underweight in interest-rate-sensitive fixed-income assets. For U.S. stocks, we expect to see short-term upgrades. Valuations are more appealing, and companies may return to buying back their own shares. We are constructive on commodities because the correction in oil has brought prices to levels that are unlikely to persist when there are positive supply/demand dynamics that can push energy prices higher. In terms of credit, we recently upgraded our position due to positive indications from our quantitative model. Also, fundamentals are better in this sector following third-quarter earnings reports.

Putnam Dynamic Asset Allocation Balanced Fund (PABYX)

Annualized total return performance as of 12/31/18

Class Y shares Inception 7/5/94	**Net asset value**	**Russell 3000 Index**	**Putnam Balanced Blended Benchmark**
Last quarter	–10.33%	–14.30%	–8.17%
1 year	–6.95	–5.24	–3.90
3 years	4.75	8.97	6.02
5 years	4.86	7.91	5.24
10 years	10.37	13.18	9.22
Life of fund	6.92	9.03	—

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 12/31/18

Class Y shares Inception 7/14/94	**Net asset value**	**Bloomberg Barclays U.S. Aggregate Bond Index**	**Putnam Conservative Blended Benchmark**
Last quarter	–5.30%	1.64%	–3.48%
1 year	–4.55	0.01	–1.92
3 years	3.27	2.06	4.22
5 years	3.74	2.52	3.97
10 years	8.02	3.48	6.62
Life of fund	5.80	5.09	—

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 12/31/18

Class Y shares Inception 7/14/94	**Net asset value**	**Russell 3000 Index**	**Putnam Growth Blended Benchmark**
Last quarter	–13.34%	–14.30%	–10.87%
1 year	–9.41	–5.24	–5.91
3 years	5.56	8.97	7.11
5 years	5.14	7.91	5.63
10 years	11.07	13.18	10.55
Life of fund	7.54	9.03	—

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

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