Q2 2020 | Putnam Small Cap Growth Fund Q&A

A strong quarter of performance despite volatile markets

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Industry since 1996

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Market conditions were volatile in the second quarter. How did the fund perform?

The fund delivered a solid return for the quarter and outperformed its benchmark, the Russell 2000 Growth Index. I am pleased to report that the fund also outperformed its benchmark for the 1-, 3-, 5-, and 10-year periods ended June 30, 2020.

Relative to its small-cap growth benchmark, your portfolio has held up well through this year's turbulence. What has helped performance?

As growth investors, we don't seek to build an overly conservative portfolio, so the severe market drawdown in the first quarter was a challenge. However, the fund performed very well relative to our benchmark due in large part to a solid base of high-quality businesses in our portfolio. Our investment approach was to focus the majority of the portfolio on companies with strong margins, solid returns, and cash-generating ability. This proved beneficial as global economies came under severe pressure. Fortunately, as we reassessed our holdings, we did not find many companies with debt levels that were high enough to hamper their future growth prospects.

What was your response to the COVID-19 crisis in terms of positioning the fund?

As the virus evolved from an emerging threat to a global crisis, we implemented a three-step approach. Steps one and two sought to mitigate downside risk for the portfolio, while the third step was aimed at finding growth opportunities. First, we focused analysis on the liquidity and debt levels of our holdings to determine which companies could weather this severe shock given it had an unknown duration. Next, we conducted deeper analysis to determine which companies might be structurally weaker in a year or two as a result of the pandemic. Step three in our process is finding companies that will be structurally stronger as a result of the pandemic.

How did you determine which companies may be structurally weaker?

It is worth noting that fewer companies declare bankruptcy than is commonly believed. However, future returns on capital and growth prospects can be diminished if liquidity and debt levels force a company to cut costs too deeply. Here, we focused on areas such as brand power and competitive market positioning, and we tried to forecast the future spending behavior of corporations and consumers.

For example, if an airline cannot fly its planes, which were acquired through loans, the business faces serious challenges. However, in many cases, the long-term impact is not as obvious. Will a regional casino operator, for example, be able to successfully conduct business with fewer patrons? If "yes," then this could present a compelling opportunity. Many restaurants could be weakened as they are forced to permanently shut locations, but a select few with strong technology and delivery offerings may actually become stronger during this tough period.

You have observed that the pandemic has enhanced growth prospects for many small companies. Can you explain?

While the nature of every crisis is different, they do have one thing in common. Crises tend to accelerate the pace of change that was already occurring — often out of necessity. In our fundamental research, we always consider disruptive change, as it is often the force that enables small companies to compete against their larger peers. We are already finding that the Covid-19 pandemic has enhanced the growth potential of many small companies, and we are seeking to add them to our portfolio.

Among the beneficiaries are companies that specialize in remotely connecting patients and health-care professionals. We believe the adoption rate of telemedicine has advanced by several years as a result of the sudden COVID-19 lockdowns and the need for social distancing. Changes brought on by the pandemic should also benefit businesses with cloud-based software offerings. Examples include companies that provide online learning services and those that enable financial institutions to offer mobile banking services.

Could you provide some more detail on the types of companies you own?

We look for small companies that we believe can grow their earnings and cash flows at a rapid pace for many years. Ideally, we seek small-cap companies that can grow into large-cap businesses over time. We are not typically attracted to companies that have been small for a while and are likely to remain small. We are attracted to businesses in big addressable markets that have products or services that enable them to take market share from peers.

The small-cap asset class can be volatile, especially when targeting the fastest growing companies. For this reason, it is important to note that the largest portion of our portfolio consists of stable, well-established companies that we believe are mispriced by the market. We believe these companies, which typically comprise 60% to 80% of the portfolio, can grow at much higher rates and the market is not pricing in their full profitability potential.

Do you also invest in more aggressive growth stocks?

The remainder of the portfolio is invested in emerging growth and cyclical growth companies. We define emerging growth companies as those that offer disruptive products, services, or technology that will enable them to grow rapidly. They are typically early in their life cycles, and their quality metrics, such as return on capital or margins, may look weak today. However, if they grow at the rates we are projecting, they could mature into high-quality growth leaders. We put less emphasis on cyclical growth companies, but we will add these to the portfolio if we believe the companies are competitively positioned and offer durable growth prospects.

What is your outlook going into the second half of 2020?

While it is well-established that the COVID-19 pandemic is a global health crisis, we are just beginning to see the economic toll it is taking on businesses. For many small-cap companies, the near-term outlook remains highly uncertain. However, we are optimistic about prospects for the asset class over the longer term. We believe the negative shock of the pandemic will reveal the strengths and weaknesses of many business models. At the same time, it should also accelerate the pace of disruptive change that many small companies help to promote.

Putnam Small Cap Growth Fund (PNSAX)

Annualized total return performance as of 6/30/20

Class Y shares Inception 11/3/03	**Net asset value**	**Russell 2000 Growth Index**
Last quarter	32.46%	30.58%
1 year	14.34	3.48
3 years	17.69	7.86
5 years	11.47	6.86
10 years	15.23	12.92
Life of fund	11.50	6.59

Total expense ratio: 0.95%

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 of class Y shares assumes reinvestment of distributions and does not account for taxes. Class Y shares, available to investors through an asset-based fee program or for institutional clients, are sold without an initial sales charge and have no CDSC. Performance for class Y shares before their inception are derived from the historical performance of class A shares (inception 12/31/97), which have not been adjusted for the lower expenses; had they, returns would have been higher. Recent performance may have benefited from one or more legal settlements. For the most recent month-end performance, please visit putnam.com.

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For informational purposes only. Not an investment recommendation.

The views and opinions expressed are those of the portfolio manager, as of June 30, 2020. They are subject to change with market conditions and are not meant as investment advice.

Consider these risks before investing: Small-cap portfolios may be subject to significant volatility and there is no guarantee the fund will acquire holdings that may capitalize on the effects of the pandemic. Growth stocks may be more susceptible to earnings disappointments, and the market may not favor growth-style investing. 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. From time to time, the fund may invest a significant portion of its assets in companies in one or more related industries or sectors, which would make the fund more vulnerable to adverse developments affecting those industries or sectors. 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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