Q4 2018 | Putnam Floating Rate Income Fund Q&A

Loans stumble but outpace high-yield bonds amid risk pullback

Paul D. Scanlon, CFA
Co-Head of Fixed Income
Industry since 1986

Norman P. Boucher
Portfolio Manager
Industry since 1985

Robert L. Salvin
Portfolio Manager
Industry since 1986

Bank loans registered their first quarterly loss in three years as investors eschewed riskier asset classes.

The fund benefited from favorable positioning in diversified media, along with underweights in food & beverages and services. On the downside, positioning in energy, housing, and cable & satellite dampened relative performance.

As we enter 2019, we have a positive outlook for market fundamentals and think valuations are more attractive.

How did high-yield bank loans perform during the fourth quarter of 2018?

Bank loans declined 3.42% for the quarter, as measured by the S&P/LSTA Leveraged Loan Index, breaking a streak of 11-straight quarterly gains. Loans outperformed high-yield bonds, but trailed the broad investment-grade fixed-income market.

Loan performance was flat in October — a relative positive in light of the risk-aversion that weighed on other asset classes. During the remainder of the quarter, however, loans were caught up in the across-the-board flight from risk that gripped the credit and equity markets.

A variety of factors weighed on the asset class during the quarter, including uncertainty about the ultimate resolution of the trade dispute between the United States and China; concern that the Federal Reserve [Fed] would raise policy rates too fast and choke off economic growth; flagging economic growth in Europe and China, leading to concern about a slowdown in growth globally; a precipitous decline in oil prices; some disappointments in third-quarter corporate earnings, particularly in the technology sector; weak stock market performance, particularly in December; and uncertainty about the ultimate resolution of the United Kingdom's exit from the European Union.

After reporting modestly negative flows in October, outflows from loan funds mounted in November and December. A total of $9.9 billion exited the asset class in December alone, the largest monthly outflow on record. A recalibration of interest-rate expectations, along with investors' reduced appetite for risk, fueled outflows.

Concerns about the global economy helped push U.S. Treasury yields lower in November and December. By quarter-end, the yield on the benchmark 10-year Treasury fell to 2.69% after trading above 3% early in the quarter. Part of the decline in yields occurred as Fed officials took a more dovish tone, and a softening in U.S. housing and business investment data became apparent.

As expected, the Fed raised its target for short-term interest rates to a range of 2.25% to 2.50% at its December 2018 policy meeting. However, the Fed reduced its forecast for 2019 rate hikes from three to two, stating that future rate increases will be "data dependent" — language that commits the Federal Open Market Committee (FOMC) to a response without committing them to a specific path. In our view, it appears that the Fed is becoming less sure about how fast it will need to act or how far it will need to go. To us, it seems clear that the central bank needs to assess how the economy is holding up under the rate increases it has already made.

Within the S&P/LSTA index, all cohorts posted losses, with metals & mining (-5%), broadcasting (-5%), and diversified media (-4%) registering the weakest results. Groups outperforming the index included more defensive sectors such as consumer products, utilities, and paper & packaging, each of which returned about -2%. From a credit perspective, lower-quality CCC-rated and split B-rated loans sold off as investors looked to shed risk, while BBB-rated credits outpaced the index. B-rated loans also outperformed, partly due to demand from collateralized loan obligations earlier in the quarter.

For the quarter, the fund modestly trailed its benchmark, the S&P/LSTA Leveraged Loan Index. What factors had the biggest influence on relative performance?

On the plus side, we benefited from favorable overall positioning in diversified media, as well as underweight allocations in food & beverages and services. Conversely, adverse positioning in energy and housing, along with overweight exposure to cable & satellite, dampened performance versus the benchmark.

What is your outlook for the bank-loan market over the coming months?

Despite global trade and political tensions, we think the fundamental backdrop for loans remains supportive, led by a strong labor market and rising employee wages. When distressed exchanges are included in calculating the loan default rate, the figure was 1.7% as of December 31, which is still well below the long-term historical average. We think default rates could remain below average for the next year or two, and possibly longer. The two key reasons for our view are the relative financial health of loan issuers overall and that many have refinanced and extended maturities into the future.

From a valuation perspective, we think the volatility and negative sentiment that resulted in materially wider spreads during the quarter created attractive investment opportunities in many areas of the market. Additionally, the average loan price within the fund's benchmark declined meaningfully from the high reached in October. As a result, we saw this period of volatility as a window of opportunity to add loans that may offer attractive total return potential.

How are you positioning the fund in light of this outlook?

During the period, we reduced risk in the portfolio by increasing the fund's allocation to higher-quality, BB-rated loans while simultaneously shrinking our overweighting in CCC-rated credits.

At the industry level, we favored gaming, lodging, & leisure; housing; and financials. Conversely, we had lower-than-benchmark exposure to food & beverages, transportation, consumer products, health care, and technology.

Within this environment, we will continue our efforts to prudently deploy capital by focusing on our research team's best ideas. This includes companies that we believe have strong balance sheets and collateral coverage, high free cash flow, manageable capital structures, and improving credit profiles.

Putnam Floating Rate Income Fund (PFRYX)

Annualized total return performance as of 12/31/18

Class Y shares Inception 10/4/05	**Net asset value**	**S&P/LSTA Leveraged Loan Index (LLI)**
Last quarter	–3.72%	–3.42%
1 year	–0.44	0.47
3 years	3.93	4.83
5 years	2.29	3.05
10 years	7.43	8.57
Life of fund	3.53	4.50

Total expense ratio: 0.77%

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 (class A share inception 8/4/04), 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 S&P/LSTA Leveraged Loan Index (LLI) is an unmanaged index of U.S. leveraged loans. You cannot invest directly in an index.

The views and opinions expressed are those of the portfolio managers as of December 31, 2018, are subject to change with market conditions, and are not meant as investment advice. Diversification does not guarantee a profit or ensure against loss. It is possible to lose money in a diversified portfolio.

Consider these risks before investing: The value of securities in the fund's portfolio may fall or fail to rise over time for several reasons, including general financial market conditions, changing market perceptions (including changing perceptions about the risk of default and expectations about monetary policy or interest rates), changes in government intervention, and factors related to a specific issuer or industry. These factors may also lead to periods of high volatility and reduced liquidity in the bond markets. Lower-rated bonds may offer higher yields in return for more risk. 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). 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. 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. Floating-rate loans may reduce, but not eliminate, interest-rate risk. These loans are typically secured by specific collateral or assets of the issuer (holders of the loan, such as the fund, have a priority claim on those assets in the event of the issuer's default or bankruptcy). Value of collateral may be insufficient to meet the issuer's obligations, and the fund's access to collateral may be limited by bankruptcy or other insolvency laws. You can lose money by investing in the fund.

For informational purposes only. Not an investment recommendation.

A world of investing.®

Putnam INVESTMENTS

Request a prospectus or summary prospectus from your financial representative or by calling 1-800-225-1581. The prospectus includes investment objectives, risks, fees, expenses, and other information that you should read and consider carefully before investing.

Putnam Retail Management

Putnam Investments | 100 Federal Street | Boston, MA 02110 | putnam.com

TL096 313762 1/19