Q2 2018 | Putnam Floating Rate Income Fund Q&A

Loans outperform as fixed-income market struggles

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For the quarter, Putnam Floating Rate Income Fund trailed its benchmark, the S&P/LSTA Leveraged Loan Index.

The fund benefited from security selection in gaming, lodging & leisure; retail; and chemicals. On the downside, picks in automotive and adverse positioning in technology dampened relative performance.

We have a positive fundamental outlook and believe bank loans remain an attractive option for investors seeking income.

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

Bank loans returned 0.71% for the quarter, as measured by the S&P/LSTA Leveraged Loan Index, marking their tenth straight quarterly gain. Loans slightly trailed high-yield bonds but outpaced the broad investment-grade fixed-income market.

Overall, despite bouts of volatility, bank loans and high-yield bonds were relative bright spots in an otherwise weak period for fixed income. Both high-yield loans and bonds benefited from continued strength in the U.S. economy, growth in corporate profits, and a decidedly positive tone in business confidence.

As the quarter began, the U.S. unemployment rate fell to 3.9% in April, its lowest level since December 2000. This development, coupled with oil prices that approached $70 per barrel, added to investor unease about inflation. Reflecting this concern, the yield on the benchmark 10-year U.S. Treasury reached 3% late in April, its highest level in more than four years, and began to weigh on investor risk appetite. Against this backdrop, loan prices rose during the first half of April, then gave back some of that gain in the second half of the month.

Not FDIC insured | May lose value | No bank guarantee

Loans posted modest gains in May and June, as volatility rose across stocks, corporate bonds, and Treasuries. Investor concerns about global trade were at the forefront of market turbulence, particularly in June.

The U.S. Treasury yield curve continued to flatten during the quarter. Short-term yields rose more than longer-term yields, reflecting market activity related to Federal Reserve policy. The Fed increased its target for short-term rates to 1.75% to 2.00% at its June policy meeting, the second hike this year and the seventh in the past three years. The three-month London Interbank Offered Rate, or LIBOR — a key pricing benchmark for leveraged loans — stayed in a narrow range during the quarter and finished at 2.34%.

Within the S&P/LSTA index, gains were broad-based across loan-market industry groups, led by metals & mining (+3%), retail (+2%), and transportation (+1%). By contrast, automotive and broadcasting were the only two categories to post negative returns. From a credit-quality perspective, lower-quality loans outperformed the market amid positive sentiment, although mid-tier B-rated loans also finished slightly ahead of the index this quarter.

What factors had the biggest influence on the fund's relative performance during the quarter?

The fund benefited from security selection in gaming, lodging & leisure; retail; and chemicals. On the downside, picks in automotive, along with adverse positioning in technology, dampened performance versus the benchmark.

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

We think the loan market continues to be supported by a favorable fundamental backdrop. U.S. gross domestic product expanded at an annual rate of 2.2% in the first quarter of 2018, slower than the 2.9% rate in the fourth quarter of 2017. While consumers reduced their spending in the first quarter, a key measure of business spending rose. Nonresidential fixed investment, which reflects investments in buildings, equipment, software, and more, grew at a robust 6.1% rate. Meanwhile, the U.S. unemployment rate fell to 3.8%, a 17-year low.

U.S. corporate profits were bolstered in the first quarter by the tax cuts enacted at the end of 2017. Earnings for companies in the S&P 500 Index grew by an average annual rate of 24%, while revenues expanded by 8%. Given the stimulus provided by a lower corporate tax rate, along with generally positive sentiment across companies, we think growth for both the U.S. economy and corporate earnings is likely to strengthen over the balance of 2018.

Within this environment, loan issuers have slowly grown their revenues and translated that growth into stronger earnings and cash flows. With the exception of specific issuers in certain parts of the market, defaults remain generally subdued.

Looking at the supply-and-demand backdrop, the majority of year-to-date gross new issuance was used to refinance existing loans — a continuation of a trend we have seen for some time. Year-to-date net new issuance of bank loans — excluding refinancing — totaled about $167 billion, up 19% from the same period in 2017. Meanwhile, loan mutual funds and

exchange-traded funds reported a year-to-date net inflow of $11.9 billion through June 29. Additionally, collateralized loan obligations [CLOs] have been a strong source of loan demand. Year to date, about $153 billion in CLOs have been issued, with roughly half this total representing new CLOs.

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

From a credit-quality perspective, the fund was overweight versus the benchmark in higher-quality, BB-rated bonds, and underweight in B-rated credits. We also had overweight exposure to select CCC-rated bonds where we had high conviction in the issuer's prospects.

At the industry level, we favored housing and gaming, lodging & leisure. Conversely, we had lower-than-benchmark exposure to retail, food & beverages, health care, technology, and automotive.

Within this environment, we will continue our efforts to deploy capital prudently 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 6/30/18

Class Y shares Inception 10/4/05	**Net asset value**	**S&P/LSTA Leveraged Loan Index (LLI)**
Last quarter	0.44%	0.71%
1 year	3.97	4.35
3 years	3.43	4.20
5 years	3.45	4.00
10 years	3.98	5.19
Life of fund	3.83	4.79

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 June 30, 2018, are subject to change with market conditions, and are not meant as investment advice.

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.

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