Q4 2020 | Putnam Floating Rate Income Fund Q&A

Bank loans rise with demand for yield

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Bank loans rose about 4% in the fourth quarter, aided by demand for higher-yielding securities.

Overweight allocations in housing and broadcasting contributed the most versus the benchmark. Conversely, adverse positioning in technology and services, along with security selection in financials, detracted.

We have a moderately constructive intermediate-term view on the market's fundamental environment and supply-and-demand backdrop.

How did the fund perform for the three months ended December 31, 2020?

The fund's class Y shares returned 3.10%, trailing the 3.81% result of the benchmark S&P/LSTA Leveraged Loan Index.

What was the fund's investment environment like during the fourth quarter of 2020?

The quarter began on a positive note, as hopes for a COVID-19 vaccine and additional fiscal stimulus led to a modest gain in October.

The high-yield loan market rallied strongly in November, gaining about 2% for the month. Encouraging vaccine news bolstered investor optimism about the strength of the economic recovery in 2021. The U.S. election outcome — a Biden victory and what appeared at the time would be a divided Congress — also boosted market sentiment. The asset class continued to rally in December amid increasing positivity about economic growth in the New Year.

Reflecting renewed investor demand for risk, bank loans outpaced investment-grade corporate bonds and the broad investment-grade fixed-income market for the quarter overall. Loans trailed high-yield bonds.

Within the S&P/LSTA index, all cohorts posted gains, led by transportation, energy, and broadcasting, each of which gained about 6%. In contrast, the more-defensive utilities and paper & packaging groups were the weakest performers versus the index, with each returning about 2%.

From a credit-rating perspective, lower-quality loans generated the highest gains, signaling increased risk appetite on the part of investors and demand for higher yields.

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

On the plus side, overweight allocations in housing and broadcasting added the most value versus the benchmark. Conversely, adverse positioning in technology and services, along with security selection in financials, detracted from relative performance.

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

As we move into 2021, we have a moderately constructive view overall. Although we expect the ongoing global health crisis to affect the high-yield loan market, we have a fairly positive intermediate-term outlook for corporate fundamentals and the market's supply-and-demand backdrop. Also, even though loan spreads retightened following their sizable widening in March, we think valuations remain relatively attractive. [Spreads are the yield advantage high-yield loans offer over comparable-maturity U.S. Treasuries.]

From a fundamental perspective, we are closely watching sectors vulnerable to the disruption caused by the pandemic. We are monitoring the impact on energy, gaming, lodging & leisure, retail, and several other cohorts. Within these groups, we are focusing on the health of issuers' balance sheets and liquidity metrics, as well as the risk of defaults or credit-rating downgrades.

As for supply/demand dynamics, net new issuance of loans [net of issuance for refinancing purposes] totaled $192.7 billion, slightly above net issuance of $192.2 billion in 2019. On the demand side, loan funds [mutual funds and exchange-traded funds] saw outflows of $26.9 billion in 2020. However, loan funds reported an inflow of $521 million in December 2020, the first inflow since September 2018.

Collateralized loan obligations [CLOs] remained a comparative bright spot for loan demand, despite lower year-over-year volume. [CLOs bundle corporate loans and sell slices of the debt to institutional investors.] For 2020, CLO volume totaled $125.1 billion compared with $161.2 billion in 2019. CLOs now account for roughly two-thirds of the total assets in the loan market, while retail funds represent only about 10%. As a result, despite fund outflows, we think the market's technical environment is neutral to favorable. Steady net new loan issuance is being met by relatively consistent CLO demand.

From a valuation standpoint, the average spread of the fund's benchmark tightened to about 4.9 percentage points over U.S. Treasuries as of period-end, below the long-term average of six percentage points. After tightening from March's extremely wide level, loan spreads compressed further on recent vaccine news. The benchmark's yield was at 5.10% as of December 31, its lowest level since mid-2014. Optimism over continued government stimulus and vaccine distribution drove loan prices higher and yields lower. Despite tighter spreads and lower yields, we think the market's yield and overall total return potential remain attractive in the face of much lower global yields.

Putnam Floating Rate Income Fund (PFRYX)

Annualized total return performance as of 12/31/20

Class Y shares Inception 10/4/05	**Net asset value**	**S&P/LSTA Leveraged Loan Index (LLI)**
Last quarter	3.10%	3.81%
1 year	0.92	3.12
3 years	2.89	4.02
5 years	4.20	5.24
10 years	3.77	4.32
Life of fund	3.66	4.66

Total expense ratio: 0.78%

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 (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, 2020, are subject to change with market conditions, and are not meant as investment advice.

Consider these risks before 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. 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 generally greater for longer-term bonds, and credit risk is generally 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 (so that 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). The 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. 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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