Q2 2019 | Putnam Floating Rate Income Fund Q&A

Loans post modest gain amid shifting Fed policy

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Bank loans rose moderately amid favorable risk sentiment, although performance was muted by changing Federal Reserve policy and declining interest rates.

The fund benefited from security selection and an overweight allocation in broadcasting. On the downside, selection in diversified media and positioning in technology dampened relative performance.

We have a positive outlook for market fundamentals but have become somewhat more cautious on valuations, given tight yield spreads and declining interest rates.

How did high-yield bank loans perform during the second quarter of 2019?

Bank loans gained 1.68% for the quarter, as measured by the S&P/LSTA Leveraged Loan Index, trailing both high-yield bonds and the broad investment-grade fixed-income market.

The asset class began the period on a strong note, outperforming high-yield bonds in April amid better-than-expected corporate earnings and improving U.S. economic growth. The tide turned somewhat in May, however, as loans registered slightly negative results amid heightened trade tensions and increasing expectations that the U.S. Federal Reserve may cut interest rates this year. Loans posted a modest gain in June, but performance remained weak as demand for loans declined due to the change in Fed intentions.

Within the S&P/LSTA index, all but one cohort posted a gain, with metals & mining registering modestly negative performance. Consumer products, broadcasting, paper & packaging, and housing were the top performers, each advancing about 3%. In addition to metals & mining, cohorts lagging the index included energy [0%], retail [+1%] and utilities [+1%]. From a credit-rating perspective, higher-quality loans generally produced the best results, while lower-quality CCC-rated credits underperformed.

The fund performed about in line with its benchmark for the quarter. What factors had the biggest influence on relative performance?

On the plus side, we benefited from favorable overall positioning in broadcasting, an overweight allocation in housing, and security selection in retail. Conversely, negative selection in diversified media, along with adverse position in technology and services, hampered performance versus the benchmark.

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

Despite global trade uncertainty, we think the fundamental backdrop for loans remains supportive, aided by favorable corporate earnings, a strong labor market, and solid U.S. economic growth. Strong exports and inventory investment helped U.S. gross domestic product grow at a 3.1% annual rate in the first quarter of 2019. That marked a significant improvement from the last three months of 2018, when the economy grew at a 2.2% rate.

After-tax corporate profits, without inventory valuation and capital consumption adjustments, fell 0.2% in the first quarter of 2019 from 2018's fourth quarter — the second-straight quarter of declining profit growth. In our view, weaker earnings growth was attributable to soft global demand, trade uncertainty, and a strong dollar, which makes U.S. exports more expensive. Corporate profits started 2018 strongly, fueled by the tax overhaul that was signed into law in late 2017, but eased as the year progressed. Looking ahead, we think earnings will continue to expand at a reasonably solid clip, but not at the same robust pace we saw in 2018.

We think the market's supply-and-demand environment changed somewhat during the past nine months. In 2016, there were massive inflows into bank loan retail funds and exchange-traded funds. However, that trend began to reverse course in October 2018 amid widespread risk aversion and a recalibration of interest-rate expectations. The asset class registered net outflows of $4.7 billion for the full year 2018, and outflows continued through the first half of 2019. Overall, we have a neutral view of the market's technical backdrop because outflows have been met by decreased issuance of new loans.

We have become somewhat more cautious on the loan market's valuation. Bank-loan spreads have tightened meaningfully this year, reflecting the Fed's more dovish tone as well as the recent easing of trade tensions. As a result, it has become more challenging to find compelling values in the market. [Yield spreads are the yield advantage loans offer over comparable-maturity U.S. Treasuries. Loan prices rise as spreads tighten and fall as spreads widen.]

Additionally, the three-month London Interbank Offered Rate [LIBOR] — the benchmark rate for bank-loan coupons [stated interest rates] — has declined significantly thus far in 2019. We think the Fed will begin reducing rates during the second half of the year as U.S. economic growth slows, which would likely cause LIBOR to drop further. This, in turn, would lead to lower income from bank loans.

How have you positioned the fund in light of this outlook?

During the quarter, we continued to reduce risk in the portfolio by decreasing our exposure to CCC-rated loans, while maintaining an overweight allocation to BB-rated credits.

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

Putnam Floating Rate Income Fund (PFRYX)

Annualized total return performance as of 6/30/19

Class Y shares Inception 10/4/05	**Net asset value**	**S&P/LSTA Leveraged Loan Index (LLI)**
Last quarter	1.72%	1.68%
1 year	3.37	3.95
3 years	4.47	5.23
5 years	3.05	3.67
10 years	5.34	6.17
Life of fund	3.80	4.74
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 June 30, 2019, 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. You can lose money by investing in the fund.

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