

## Q1 2022 | Putnam Floating Rate Income Fund Q&amp;A

# Bank loans outperform most assets as rate increases begin



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Industry since 1985

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Industry since 1990  
(Photo not available)



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Industry since 1986

Paul D. Scanlon, CFA, a Portfolio Manager of the fund, retired from Putnam effective March 31, 2022.

***High-yield bank loans posted breakeven performance in the first quarter. This was good enough to outpace most other fixed income categories amid rising interest rates.***

***Security selection in the services and health care sectors detracted from relative performance this quarter.***

***We have a positive outlook for the loan market's fundamental environment and supply-and-demand dynamics but are more neutral toward valuation.***

## How did the fund perform for the three months ended March 31, 2022?

The fund's class Y shares returned -0.50%, trailing the -0.10% result of the benchmark S&P/LSTA Leveraged Loan Index.

## What was the fund's investment environment like during the first quarter of 2022?

Despite losses across global fixed income and equity markets, leveraged loans performed relatively well. The shift to a more restrictive interest-rate policy by the U.S. Federal Reserve sparked demand for floating-rate debt.

During the quarter, the 3-month London Interbank Offered Rate [LIBOR] — a key pricing mechanism for loans — rose from 0.22% to 0.96%. This increase was in response to the Fed's announcement that it would begin raising its target for short-term interest rates in March. On March 16, the central bank approved a 0.25% hike, its first increase since December 2018. Fed Chair Jerome Powell signaled an aggressive approach going forward, indicating that additional hikes could occur at each of the remaining six policy meetings in 2022.

Within the loan market, after positive performance in January, prices turned lower in February, reflecting a retreat from risk assets amid the Russian invasion of Ukraine. It was only the third time in 23 months that loans posted negative performance. Loans essentially broke even in March, but that was good enough to outperform most other fixed income categories for the month.

Within the fund's benchmark, gains and losses among industry cohorts were about evenly divided. On the plus side, energy [+1%] and metals & mining [+2%] were among the best performers. Commodities such as oil, wheat, and metals experienced large price increases during the quarter on expectations of global shortages resulting from Russia's invasion of Ukraine. Cable & satellite and services each gained about 1% and also outperformed the benchmark. On the negative side of the ledger, broadcasting, consumer products, and telecommunications were the weakest groups, with each returning about -1%. From a credit-rating perspective, returns were comparable among credits rated BBB, BB, and B, and loans in each of these ratings categories significantly outpaced lower-quality loans.

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

Security selection in the services and health care sectors dampened performance versus the benchmark.

#### **What is the team's outlook for the bank loan market over the coming months?**

We have a positive outlook for the loan market. Our view is based on what we consider to be strong fundamentals and a favorable overall supply-and-demand backdrop. Our view on valuation is more neutral, given the relative tightness of yield spreads in the market as of quarter-end. That said, loan spreads widened during the quarter and, we believe, are more attractive than high-yield bond spreads. [Spreads are the yield advantage loans and credit-sensitive bonds offer over comparable-maturity U.S. Treasuries.]

Despite a substantial increase in loan supply, we think the market's technical environment is favorable. In addition to steady institutional demand from CLOs, headlines about higher interest rates continued to spark demand for loans from individual investors. [CLO stands for collateralized loan obligation. These vehicles bundle corporate loans and sell slices of the debt to institutional investors.] March 2022 was the sixteenth consecutive month of flows into loan funds [mutual funds and exchange-traded funds]. Given the floating-rate nature of loan coupons, if short-term interest rates continue to rise in 2022, loan coupons will adjust higher. [A coupon is a loan's stated interest rate.]

As of period-end, U.S. economic growth expectations had moderated somewhat. However, we believe U.S. gross domestic product will continue to grow at a rate above the longer-term trend in 2022. Following robust corporate earnings growth in 2021, market expectations for 2022 were adjusted down to the low double-digit range. Despite decelerating economic and corporate profit growth, credit metrics and ratings continued to improve for loan issuers, in our view. Moreover, we believe issuers continued to benefit from strong demand for credit risk.

All these factors resulted in a very low default rate. Including distressed exchanges, the U.S. leveraged loan default rate ended the quarter at 0.86%. This was well below the long-term average of 3.1%.

In light of our long-term, constructive outlook on the loan market, we have been adding resources to our investment team. The additional resources have enabled us to expand our coverage of corporate loan issuers, thereby generating broader investment opportunities in both the primary and secondary markets. Given the expectation for multiple interest-rate increases during 2022 and a generally healthy fundamental credit environment, we have been selectively adding higher-yielding assets to the fund.

## How was the portfolio positioned as of March 31, 2022?

During the first quarter, consistent with our modest repositioning of the portfolio, we trimmed five holdings while adding 18 new positions. These changes added more than 1% to the fund's yield to maturity. The fund remains well diversified across issuers and industries, with no single industry accounting for more than 20% of the fund. The fund's largest industry exposure was technology, which was held at a roughly equal weight to the benchmark.

Our credit analysts are sector specialists and cover the full ratings spectrum, from investment-grade to lower-quality, more-speculative issuers. As of March 31, the corporate ratings distribution for the portfolio was 4.5% BBB, 32.8% BB, 53.1% B, and 2.0% CCC and below.

So far this year, we have increased the fund's exposure to corporate issuers with B ratings, while trimming some of our investment-grade or near-investment-grade issuers. We believe this repositioning should enhance the current income of the portfolio and may provide some price appreciation potential. At the same time, we believe it keeps the portfolio's risk profile consistent with the fund's objective.

## Putnam Floating Rate Income Fund (PFRYX)

Annualized total return performance as of 3/31/22

	Class Y shares Inception 10/4/05	S&P/LSTA Leveraged Loan Index (LLI)
Last quarter	-0.50%	-0.10%
1 year	1.95	3.25
3 years	2.64	4.24
5 years	2.85	4.01
10 years	3.45	4.30
Life of fund	3.55	4.62

Total expense ratio: 0.79%

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 March 31, 2022, 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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