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Q1 2019 | Putnam Floating Rate Income Fund Q&A

Loans rally but trail high-yield bonds

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 recovered amid improving risk sentiment, although performance was muted by changing Federal Reserve policy and declining interest rates.

The fund benefited from overweighting the rallying energy sector. On the downside, positioning in food & beverages dampened relative performance.

We have a positive outlook for market fundamentals but have a more neutral stance toward valuations and the market's supply-and-demand backdrop.

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

Bank loans gained 3.96% for the quarter, as measured by the S&P/LSTA Leveraged Loan Index, trailing high-yield bonds, but outperforming the broad investment-grade fixed-income market.

Following a sharp downturn in 2018's fourth quarter, the bank loan market rallied in early January 2019 and stabilized as the month progressed. Risk sentiment improved in January following comments from Federal Reserve Chair Jerome Powell that mild inflation would give the central bank greater flexibility to set policy in 2019. Market participants also welcomed Powell's announcement that the Fed was not on a "pre-set" path to push its benchmark rate higher, after hiking rates every quarter in 2018. Better-than-expected corporate earnings, a rebound in oil prices, and progress in U.S.-China trade talks were additional factors fueling the recovery.

The asset class posted another solid gain in February, as credit market conditions continued to recover and the market's supply-and-demand backdrop improved. Net issuance of collateralized loan obligations [CLOs] rose, and outflows from actively managed loan funds receded. [CLOs bundle corporate loans and sell slices of the debt to institutional investors.]

The tide shifted somewhat in March, and loan prices declined slightly. Market participants continued to recalibrate interest-rate expectations in light of the Fed's policy shift. Also, outflows from retail and exchange-traded funds [ETFs] accelerated, fueled by a sharp slide in rates during the month.

Within the S&P/LSTA index, all cohorts posted gains, led by broadcasting, energy, and food & beverages, each of which returned 5%. Industries that lagged the index included diversified media [+1%], utilities [+3%], and consumer products [+3%]. Gains were positive and in a tight range across credit-quality tiers, with higher-quality BB and split BBB-rated loans producing the best results.

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 a sizable overweight allocation in the rallying energy sector. Overweights in housing and cable & satellite also aided relative performance. Conversely, adverse positioning in food & beverages, along with lighter-than-benchmark allocations in telecommunications and transportation, dampened performance versus the benchmark.

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

Despite uncertainty surrounding the ultimate outcome of U.S.-China trade negotiations, we think the fundamental backdrop for loans remains supportive, led by a strong labor market and rising employee wages. Gross domestic product, the broadest measure of goods and services produced across the economy, was revised downward to a 2.2% annual rate in 2018's fourth quarter. We did not find this surprising, however, because we expect growth to moderate as the immediate benefits of a lower corporate tax rate recede. That said, we do not believe a recession is likely in 2019.

After-tax corporate profits, without inventory valuation and capital consumption adjustments, declined 1.7% in 2018's fourth quarter from the third quarter. This was the first quarter-over-quarter decline in profits since the final quarter of 2017. Profits rose 11.1% in 2018's fourth quarter from a year earlier, which was the largest year-over-year gain since the first quarter of 2017. The broad trend depicted by these data suggest that profits started 2018 strongly 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.

While we continue to have a positive view of the loan market's fundamental backdrop, we are monitoring changes in issuance trends fueled by market growth. Issuance has become skewed toward uses that tend to increase issuer indebtedness, such as mergers and acquisitions and leveraged buyouts. Over time, this trend could lead to a higher level of issuer defaults and lower recovery rates.

We think the market's supply-and-demand environment changed somewhat during the past six months. Stretching back to 2016, there were massive inflows into bank loan retail funds and ETFs. 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 in the first quarter of 2019. Overall, we have a neutral view of the market's technical backdrop, because outflows have been met by a recent decrease in new issuance.

As for valuation, by quarter-end, bank loan spreads had retraced most of their recent widening back to the tight level we saw prior to 2018's fourth quarter. As a result, it has become more challenging to find compelling values in the market. From an income perspective, the average yield of the fund's benchmark was 7% as of March 31 — above the long-term median of 6.6%. [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.]

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

During the period, we reduced risk in the portfolio by continuing to decrease 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 3/31/19

Class Y shares Inception 10/4/05	**Net asset value**	**S&P/LSTA Leveraged Loan Index (LLI)**
Last quarter	4.08%	3.96%
1 year	2.19	2.96
3 years	4.61	5.65
5 years	2.94	3.61
10 years	6.80	7.98
Life of fund	3.75	4.70
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 March 31, 2019, 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 perceptions about the risk of default and expectations about monetary policy or interest rates), changes in government intervention in the financial markets, and factors related to a specific issuer or industry. These and other factors may lead to periods of high 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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Putnam Investments | 100 Federal Street | Boston, MA 02110 | putnam.com

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