Q2 2020 | Putnam Floating Rate Income Fund Q&A

Bank loans rebound strongly following coronavirus upheaval

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High-yield bank loans advanced nearly 10% the past three months, rebounding from an extreme, but short-lived, period of risk aversion in March.

Greater-than-benchmark exposure to housing and favorable positioning in broadcasting contributed the most versus the benchmark. Conversely, positioning in technology, services, and health care detracted from relative performance.

Despite considerable uncertainty, 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 June 30, 2020?

The fund's class Y shares returned 7.39%, trailing the 9.70% result of the benchmark S&P/LSTA Leveraged Loan Index.

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

Following their partial recovery in late March, bank loans continued to rebound in April on hopes that massive government stimulus efforts would be enough to offset the near-term economic fallout from the coronavirus pandemic. The market rally continued in May, aided by an easing of coronavirus restrictions and additional policy support. These developments reinforced investors' view that global economic activity had bottomed and would begin to recover, albeit gradually.

The pace of the loan recovery moderated in June. Investors weighed the potential for more support from the U.S. Federal Reserve, along with better-than-expected economic data, against an accelerating rate of coronavirus infections in certain parts of the country. Market participants worried that the possibility of a second wave of infections could slow progress toward the economy reopening.

For the quarter as a whole, high-yield bank loans performed in line with high-yield bonds. Reflecting renewed investor demand for risk, both asset classes handily outperformed the broad investment-grade fixed-income market.

Not FDIC insured | May lose value | No bank guarantee

Within the S&P/LSTA index, all cohorts posted gains, led by a 26% retracement in the energy group, following last quarter's -30% return. Automotive [+13%], chemicals [+13%], housing [+12%], and metals & mining [+12%] also registered strong advances. Conversely, transportation [+4%], cable & satellite [+5%], and telecommunications [+7%] notably lagged the fund's benchmark. From a credit-rating perspective, lower-quality loans generated the highest gains, rallying back from the oversold levels reached amid the flight from risk that occurred in March.

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

On the plus side, a larger-than-benchmark allocation in housing and favorable positioning in broadcasting helped the most versus the benchmark. On the downside, adverse positioning in technology, services, and health care detracted from relative performance.

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

We have a moderately constructive outlook overall. The biggest risk on the horizon is the still-to-be-determined impact of the coronavirus pandemic on economic growth, corporate earnings growth, and cash flows.

That said, except for the energy sector, we have a fairly positive intermediate-term view on corporate fundamentals and the market's supply-and-demand backdrop. Also, even though loan spreads retightened somewhat following their sizable widening in March, we think valuations remain relatively attractive. [Spreads are the yield advantage loans offer over comparable-maturity U.S. Treasuries.]

From a fundamental perspective, we are closely watching sectors vulnerable to the disruption caused by the coronavirus. In addition to energy, we are monitoring the impact on 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 increasing risk of defaults or credit-rating downgrades.

As for supply/demand dynamics, new loan issuance did not experience the resurgence seen in the high-yield bond market. While new issuance picked up in June, total issuance for the second quarter was only $46.4 billion, the lowest amount in more than four years. On a year-to-date basis through June, new-issue volume totaled $245.5 billion, a 56% increase over the same period in 2019. However, much of this issuance occurred in the early months of the year. On the demand side, loan funds [mutual funds and exchange-traded funds] saw outflows of $21 billion year to date.

Collateralized loan obligations [CLOs] remained a relative bright spot for loan demand, despite lower year-over-year volume. [CLOs bundle corporate loans and sell slices of the debt to institutional investors.] Year to date through June, CLO volume totaled $59.3 billion compared with $89 billion for the first half of 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 continued fund outflows, we think the market's technical environment is favorable. Decreased issuance of new loans is being met by consistent CLO demand.

From a valuation standpoint, the average spread of the fund's benchmark rose 4.9 percentage points during March to about 10 percentage points over Treasuries. This was the highest spread level since mid-2009 and was well above the 11-year average of 5.7 percentage points. The benchmark's average yield spiked to 10.5% during this time. As of period-end, spreads had tightened to 6.9 percentage points over Treasuries and the benchmark's yield was at 7.1%. In our view, spreads at this level continue to offer a broad range of attractive relative-value investment opportunities. Moreover, we think the market's yield remains compelling in the face of much lower global yields.

In addition to coronavirus, risks to our outlook include price volatility in oil and other commodities, policy missteps by global central banks, and heightened geopolitical tension.

Putnam Floating Rate Income Fund (PFRYX)

Annualized total return performance as of 6/30/20

Class Y shares Inception 10/4/05	**Net asset value**	**S&P/LSTA Leveraged Loan Index (LLI)**
Last quarter	7.39%	9.70%
1 year	–2.71	–1.96
3 years	1.49	2.07
5 years	2.16	2.89
10 years	3.80	4.18
Life of fund	3.37	4.30

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, 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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