Q3 2018 | Putnam Floating Rate Income Fund Q&A

Loans gain as investment-grade bonds struggle

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Bank loans registered their eleventh straight quarterly gain in the three months ended September 30, 2018, as measured by the S&P/LSTA Leveraged Loan Index.

The fund benefited from overweight sector allocations to energy, housing, and gaming, lodging, & leisure. On the downside, security selection in retail, along with underweights in diversified media and technology, dampened relative performance.

We have a positive fundamental outlook and believe bank loans remain an attractive option for investors seeking income.

Not FDIC insured | May lose value | No bank guarantee

How did high-yield bank loans perform during the third quarter of 2018?

Bank loans returned 1.82% for the quarter, as measured by the S&P/LSTA Leveraged Loan Index, marking their eleventh straight quarterly gain. Loans modestly trailed high-yield bonds, but outpaced the broad investment-grade fixed-income market. The asset class benefited from continued strength in the U.S. economy, growth in corporate profits, and a decidedly positive tone in business confidence. As of September 30, loans had registered gains in 27 of the preceding 28 months.

Loans began the period on a positive note, bolstered by trade talks between the United States and Europe, along with strong second-quarter earnings. The asset class continued to show strength in August and September, aided by a robust 4.2% annualized growth rate for U.S. gross domestic product [GDP] in the second quarter of 2018. Stronger business investment, fueled by solid earnings, drove U.S. GDP growth. U.S. corporate earnings rose 25% in the second quarter, boosted by a lower corporate tax rate, but the pace may have moderately slowed in the third quarter.

The supply-and-demand backdrop for the loan market has been strong thus far in 2018. Year-to-date through September 30, net new issuance of loans — excluding those issued for repricing/refinancing — totaled $238 billion, up 21% from the same period in 2017. Collateralized loan obligations [CLOs] have been a robust source of demand for new loans. Year-to-date, about $219 billion in CLOs have been formed, with roughly half

this total representing new issues. CLOs are structured investment vehicles in which bank loans are pooled to create income streams with different risk-and-return characteristics. Additionally, loan mutual funds and exchange-traded funds [ETFs] reported combined net inflows of $15.5 billion for the first nine months of 2018.

It is also notable that $200 billion in loans were used to fund mergers and acquisitions so far in 2018, composing 34% of total gross issuance compared with 22% for the first nine months of 2017. This activity reflects a growing trend of private-equity firms completing transactions via the loan market rather than the high-yield bond market.

As expected, the Federal Reserve raised its target for short-term interest rates to a range of 2% to 2.25% at its September policy meeting, the third hike this year and the eighth in the past three years. U.S. Treasury yields rose across the curve during the third quarter, as investors anticipated that the Fed would continue to hike interest rates at a steady pace. At the same time, accelerating economic growth increased the potential for inflation to pick up.

Within the S&P/LSTA index, all cohorts generated gains, with retail (+5%), paper & packaging (+3%), and diversified media (+3%) leading the way. By contrast, metals & mining, broadcasting, and consumer products were the weakest performers, with each returning roughly 1%. From a credit perspective, lower-quality CCC-rated and split B-rated loans delivered the best results, reflecting investor confidence amid the solid fundamental backdrop.

For the quarter, the fund modestly trailed its benchmark, the S&P/LSTA Leveraged Loan Index. What factors had the biggest influence on its relative performance?

The fund benefited from overweight allocations to energy, housing, and gaming, lodging, & leisure. On the downside, security selection in retail, along with underweights in diversified media and technology, dampened performance versus the benchmark.

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

Despite global trade and political tensions, we think the fundamental backdrop for loans remains supportive, led by a strong labor market and rising employee wages. Including distressed exchanges, the loan default rate was 1.8% as of September 30, still well below the long-term historical average. We think default rates could remain below average for the next year or two, and possibly longer, for two key reasons: the relative financial health of loan issuers overall, and the fact that many have refinanced and extended maturities into the future.

From a valuation perspective, the average spread over the three-month London Interbank Offered Rate [LIBOR] in the fund's S&P/LSTA benchmark was about 3.8 percentage points at quarter-end — below where it began the year and also below the long-term average. Spreads in the loan market have compressed due to the volume of refinancing that has occurred, as loans get repriced with lower coupons. Despite this, we believe valuation remains reasonably attractive relative to longer-term historical averages, given the current fundamental environment. That said, we think most of the fund's return for the foreseeable future is likely to come from coupon income. The good news in that regard is that a higher three-month LIBOR — a key pricing benchmark for loans — has helped boost the current income level of existing loans, despite tighter spreads.

Overall, we continue to have an optimistic outlook. The loan market recently surpassed $1 trillion, and we think its growth is likely to continue. An expanding market should provide the fund with more investment opportunities and would allow us to broaden the portfolio's diversification.

How are you positioning the fund in light of this outlook?

In terms of credit quality, the fund had underweight allocations versus the benchmark in BB- and B-rated loans, and overweight exposure to select CCC-rated credits where we had high conviction in the issuer's prospects. We are looking to trim our CCC exposure, given strong performance and also with an eye toward reducing overall portfolio risk.

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

Within this environment, we will continue our efforts to prudently deploy capital by focusing on our research team's best ideas. This includes companies that we believe have strong balance sheets and collateral coverage, high free cash flow, manageable capital structures, and improving credit profiles.

Putnam Floating Rate Income Fund (PFRYX)

Annualized total return performance as of 9/30/18

Class Y shares Inception 10/4/05	**Net asset value**	**S&P/LSTA Leveraged Loan Index (LLI)**
Last quarter	1.53%	1.82%
1 year	4.49	5.18
3 years	4.49	5.31
5 years	3.45	4.13
10 years	4.97	6.15
Life of fund	3.87	4.84
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 September 30, 2018, 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 changing perceptions about the risk of default and expectations about monetary policy or interest rates), changes in government intervention, and factors related to a specific issuer or industry. These factors may also lead to periods of high volatility and reduced liquidity in the bond markets. 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 greater for longer-term bonds, and credit risk is 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 (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). 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 Retail Management

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