

Q2 2021 | Putnam Floating Rate Income Fund Q&A

Loans generate positive performance amid demand for yield



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High-yield bank loans posted a modest gain in the second quarter, aided by demand for higher-yielding securities and overall economic optimism.

Security selection and underweight allocations in the technology and services sectors, along with picks in financials, detracted from relative performance this quarter.

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

How did the fund perform for the three months ended June 30, 2021?

The fund's class Y shares rose 1.16%, trailing the 1.47% return of the benchmark S&P/LSTA Leveraged Loan Index.

What was the fund's investment environment like during the second quarter of 2021?

High-yield bank loans rallied in April amid favorable sentiment toward risk assets, ongoing fund inflows, and CLO origination occurring at a record pace. [CLO stands for "collateralized loan obligation." These vehicles bundle corporate loans and sell slices of the debt to institutional investors.]

Leveraged loans outperformed their fixed-rate peers in May, as investors weighed advancing Covid-19 vaccination campaigns, accelerating economic growth, and strong earnings against a rise in inflation. Following the announcement of the highest Consumer Price Index reading since 1982, some U.S. Federal Reserve governors indicated openness to discussing when the Fed should begin reducing its bond purchase program. These developments led to brief periods of volatility for interest rates and stocks, while loan prices proved relatively resilient.

The asset class posted another modest gain in June but lagged its fixed-rate peers amid receding inflation concerns and heavy capital market activity. That said, there was no indication of slowing demand for floating-rate loans.

Relative to other asset classes, loans trailed high-yield bonds and the broad investment-grade fixed-income market this quarter.

Within the fund's benchmark, every cohort generated a positive result with returns in a fairly tight range. Energy [+3%] was the best-performing group, powered by a 24% advance in the price of U.S. crude oil. Other outperformers included transportation; gaming, lodging & leisure; and services, each of which gained about 2%. Utilities [+0.3%] and broadcasting [+0.1%] were the weakest performers. From a credit-rating perspective, lower-quality loans outperformed the benchmark, signaling a comfort level with risk as investors sought higher yields.

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

Security selection and underweight allocations in the technology and services sectors, along with picks in financials, hampered 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 loan market fundamentals and the 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. Our optimism is grounded in the rapidly growing percentage of Americans receiving Covid-19 vaccines, sustained government stimulus, and the continuing recovery of the U.S. economy. That said, we continue to closely monitor issuers' balance sheets and liquidity metrics, with an eye toward default risk or a credit-rating downgrade. Risks to our generally constructive outlook include any new developments with Covid-19, volatility in commodity prices, and policy missteps from global central banks.

Expectations for defaults have meaningfully improved this year, given the liquidity in the market. Many troubled issuers have been given the lifeline they need to continue operating. Including distressed exchanges, the U.S. leveraged loan default rate ended the quarter at 1.43%, down substantially from 3.15% at the end of last June. The departure of large default/distressed totals from June 2020 helped lower the rolling 12-month default rate calculation.

As for supply/demand dynamics, new issuance of loans totaled \$494.9 billion on a year-to-date basis through June 2021, more than double the amount issued during the same period last year. About 62% of this year's new issuance has been used to refinance existing debt. On the demand side, loan funds [mutual funds and exchange-traded funds] posted inflows of \$26.8 billion for the second quarter compared with outflows of \$22.1 billion during the same period in 2020.

CLOs continued to be a major source of loan demand this period. In June, gross CLO volume reached the second-highest monthly total ever recorded. Year to date through June 30, CLO volume equaled \$215 billion, compared with \$59.8 billion in the first half of 2020.

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 a substantial increase in loan supply, we think the market's technical environment is favorable. Stronger demand from both retail investors and CLOs is meeting higher net new loan issuance.

From a valuation standpoint, the average yield spread of the fund's benchmark tightened to 4.2 percentage points over 10-year U.S. Treasuries as of quarter-end, below the long-term average of 6 percentage points. The benchmark's yield was 4.76% as of June 30, significantly below its 11-year average of 7.29%. Optimism over government stimulus and vaccine distribution continued to drive loan prices higher and yields lower this quarter. Despite tighter spreads and lower yields, we think the market's income potential remains attractive in the face of much lower global yields.

Putnam Floating Rate Income Fund (PFRYX)

Annualized total return performance as of 6/30/21

	Class Y shares Inception 10/4/05	S&P/LSTA Leveraged Loan Index (LLI)
Last quarter	1.16%	1.47%
1 year	8.44	11.65
3 years	2.93	4.40
5 years	3.76	4.99
10 years	3.74	4.39
Life of fund	3.67	4.72

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 June 30, 2021, 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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