Q1 2018 | Putnam Floating Rate Income Fund Q&A

Loans offer haven from rate and credit risk

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

For the quarter, Putnam Floating Rate Income Fund performed in line with its benchmark, the S&P/LSTA Leveraged Loan Index.

The fund benefited from favorable overall positioning in housing and broadcasting, along with security selection in consumer products. On the downside, adverse positioning in health care dampened relative performance.

We have a positive fundamental outlook, but think that the fund's return will mostly come from coupon income.

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

Floating-rate loans performed well in the early months of 2018 amid a volatile backdrop for risk-driven assets. Rising interest rates bolstered the asset class, as loan coupons — their stated interest rates — adjusted higher. For the first quarter, loans returned 1.45%, as measured by the S&P/LSTA Leveraged Loan Index, marking their ninth-straight quarterly gain, and outpacing both high-yield bonds and the broad investment-grade fixed-income market.

In January, loans gained 0.99%, registering their strongest performance since December 2016, as a sharp rise in U.S. Treasury yields increased the allure of floating-rate securities. Loans were relatively immune to the volatility that hampered stocks and credit in February and March, and the asset class posted modestly positive returns in both months.

The yield on the 10-year Treasury posted its largest quarterly increase since December 2016, boosted by surging expectations for growth and inflation in the wake of a $1.5 trillion tax cut that was passed at the end of last year. Data showed wages and consumer prices rose in January, encouraging more investors to sell government bonds and driving the yield on the 10-year Treasury more than half a percentage point higher in less than two months. But the rise in yields stalled in March. Strong January wage data were revised lower in the following month's labor report. Subsequent weaker-than-forecast inflation data suggested the tax cuts were unlikely to spur growth that matched the move in market expectations. Rising bond yields also attracted buyers. After reaching 2.94% on February 21 — its high for the period — the 10-year yield finished the quarter at 2.74%.

Against this backdrop, gains were broad-based across loan-market industry groups. In fact, every cohort within the S&P/LSTA index had positive performance, led by retail (+3%), metals & mining (+2%), and consumer products (+2%). By contrast, diversified media, industrials, and gaming, lodging & leisure lagged the index. From a credit-quality perspective, lower-quality loans outperformed the market amid positive sentiment. Higher-quality BB-rated loans also did well, finishing fairly close to the index's return.

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

At the sector/industry level, the fund benefited from favorable overall positioning in housing and broadcasting, along with security selection in consumer products. On the downside, adverse positioning in health care dampened performance versus the benchmark.

What is your view on tax reform as it relates to the loan market?

Overall, we think the new Tax Cuts and Jobs Act is positive for U.S. corporations. While analysis of the law's intricacies continues to emerge, we think a lower corporate tax rate — it dropped from 35% to 21% — will bolster cash flows. At the same time, the new tax law caps interest deductibility at 30% of earnings before interest, taxes, depreciation, and amortization, which, in our view, will sap cash flows for more heavily indebted, lower-rated debt issuers.

Based on our preliminary analysis, a large majority of companies in the high-yield and bank-loan markets will benefit from tax reform. The firms that may be disadvantaged are lower-rated issuers — those with credit ratings of CCC or lower — and we think the impact will likely occur over a two- to five-year period. It's also important to note that the bank-loan market has significantly fewer CCC-rated issuers versus the high-yield bond market. Thus, the loan market is less exposed to the potential negative implications that may affect lower-rated issuers.

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

Bank-loan coupons are linked to the London Interbank Offered Rate [LIBOR] — a widely used benchmark for short-term lending among banks, which tends to move in step with the federal funds rate. In late February, the three-month LIBOR eclipsed 2% for the first time since the 2007–2008 financial crisis. We think it's possible that the Federal Reserve could increase the fed funds rate four times during 2018. If that occurs, LIBOR also would likely continue to rise, and coupons on existing loans would, in turn, likely adjust higher from current levels, providing the fund with incrementally higher income.

More broadly, we think the loan market continues to be supported by a favorable fundamental backdrop. The U.S. economy continues to expand, aided by a reacceleration in global growth. Corporate fundamentals — sales, earnings, cash flow, and debt management — have continued to strengthen, in our view, providing a supportive environment for risk-based assets, including bank loans. The loan default rate rose to 2.5% during the first quarter, but remained below the long-term average range of 3% to 3.5%. Importantly, we believe strong sales and earnings among loan issuers, coupled with a record pace of refinancing, may extend the current credit cycle for at least a few more years.

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

At the sector/industry level, we favor housing; gaming, lodging & leisure; paper & packaging; chemicals; and financials. Conversely, we had an underweight in retail — which we plan to continue — due to fundamental concerns about the industry, along with increased competitive pressure. The fund also had lighter-than-benchmark exposure to technology, services, and transportation.

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 3/31/18

Class Y shares Inception 10/4/05	**Net asset value**	**S&P/LSTA Leveraged Loan Index (LLI)**
Last quarter	1.40%	1.45%
1 year	4.26	4.40
3 years	3.59	4.19
5 years	3.34	3.89
10 years	4.45	5.62
Life of fund	3.86	4.83

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 (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, 2018, are subject to change with market conditions, and are not meant as investment advice.

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 Investments | One Post Office Square | Boston, MA 02109 | putnam.com

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