Fund outperforms as Fed turns attention to cutting rates

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Credit selection and fundamental conviction were key factors in the fund's outperformance of the benchmark during the quarter.

General market consensus of expected defaults has come down over the past twelve months.

How were market conditions in the fourth quarter?

While mixed economic data and geopolitical concerns persisted during the fourth quarter, there is increasing optimism about the U.S. Federal Reserve's ability to achieve a soft landing. In addition, investors closely monitored central bank actions and policymakers' comments for hints of when the Fed may begin to cut the federal funds rate. For the quarter, corporate credit spreads were tighter than recent averages while the Morningstar LSTA US Leveraged Loan Index marched 150 bps higher to end the year at 96.2.

The Fed left the policy rate unchanged at its November and December meetings. Data showed growth had eased and the labor market had moderated, although the unemployment rate remained low, at 3.7%. Inflation continued to ease but remained above the central bank's target. In the final weeks of the period, Fed Chair Jerome Powell reiterated that the central bank would continue to be dependent on incoming economic data. At the same time, the Fed's outlook suggested that rate cuts may be considered in 2024. The 10-year U.S. Treasury note yield of 4.59% on September 29 rose to new highs briefly during the fourth quarter, before declining to 3.88% on December 29.

Floating-rate loans had a positive return but underperformed fixed income markets for the fourth quarter owing largely to the strong shift in the expected path for rates. The Morningstar LSTA US Leveraged Loan Index, the fund's benchmark, returned 2.84%. IG corporate bonds, as measured by the Bloomberg U.S. Corporate Bond Index, returned 8.50%, and high-yield corporate bonds, as measured by the JPMorgan Developed High Yield Index, returned 6.82%.

How did the fund perform for the three months ended December 31, 2023?

The fund's class Y shares returned 3.17%, outperforming the Morningstar LSTA US Leveraged Loan Index by 33 bps.

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

Credit selection and, more specifically, our fundamental conviction and HOLD ratings for several companies with loans trading in the 80s, were key factors in the strong Q4 performance. The fund benefited in the quarter from fifteen positions that traded up by five points or more. The largest gain was 8.5 points. These results compared with only three positions that traded down by five or more points. The largest decliner was down 10 points. Of note, 11 of the 15 top gainers were corporate bonds. The fund maintained 9.0%–10.5% corporate-bond exposure throughout the year.

What is the team's near-term outlook for the leveraged loan market?

During much of Q4 2023 and even early 2024, technical conditions have been quite supportive of leveraged loans. Mutual fund flows have turned positive, collateralized loan obligation (CLO) formation has picked up, and Q3 2023 earnings were encouraging, for the most part. Looking ahead, we believe CLO issuance will be noticeably higher in 2024, owing in no small part to the return of domestic banks as a key investor bloc for AAA liabilities, which should help to restore a favorable cash flow arbitrage for the equity investor. In terms of retail fund flows, we anticipate balancing effects as investors weigh a variety of potentially competing factors, such as the persistence of attractive yields — currently 9.5% — and the positive fundamental impact on leveraged issuers of future rate cuts (lowering debt service costs), against recent Fed guidance of a shift in its rate stance, which is likely to bring the basis or "floating" component of returns lower.

Our twelve-month outlook for loan defaults (including actual defaults and distressed exchanges that result in par losses) across the asset class is 3.75%–4.00% compared to 3.2% currently. It is important to note that general market consensus of expected defaults has come down over the past twelve months. Moreover, loan price volatility has decreased steadily from a peak of 13.7% in April 2023 to 11.5% at year-end. The inflection point in this metric (defined as one weighted standard deviation of loan prices in the Morningstar LSTA US Leveraged Loan Index divided by the Index level) has historically marked the beginning of a sustained recovery in the asset class. This is what we saw in 2023.

Net new issuance remains subdued. In fact, the leveraged loan market contracted in 2023, the first contraction since 2010. Debt issuers are primarily focused on refinancing near-term maturities and taking advantage of tightening spreads to reprice loans lower. With nearly 70% of the loan market trading at 99+, we are expecting the repricing/refinancing wave to continue, which should keep prices range-bound. Stress in the loan market will remain idiosyncratic, and prudent selection of credits remains critical, but overall, we are constructive on loans and see potential for a 9%–10% return year.

Putnam Floating Rate Income Fund (PFRYX)

Annualized total return performance as of 12/31/23

	Class Y shares Inception 10/4/05	**Morningstar LSTA US Leveraged Loan Index**
Last quarter	3.17%	2.84%
1 year	12.88	13.29
3 years	4.76	5.74
5 years	4.69	5.78
10 years	3.48	4.41
Life of fund	3.83	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 (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 Morningstar® LSTA® US Leveraged Loan Index 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 December 31, 2023, 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.

Credit qualities are shown as a percentage of the fund's net assets. A bond rated BBB or higher (A–3/SP–3 or higher, for short-term debt) is considered investment grade. The information provided reflects the highest security rating provided by one or more of Standard & Poor's, Moody's, and Fitch. Ratings and portfolio credit quality will vary over time. The fund itself has not been rated by an independent rating agency.

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