Q3 2017 | Putnam Floating Rate Income Fund Q&A

Fund rises on conservative positioning as defaults ebb

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 an overweight allocation to energy, along with security selection in several other industry groups.

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

What was the market environment like for high-yield bank loans during the third quarter of 2017?

Bank loans posted a modest positive return for the quarter, with virtually all of the gain coming from coupon income.

In July, loans registered their best performance for the year-to-date period, bolstered by favorable corporate earnings results, improving flows into retail funds, and a steady increase in bond prices. Issuance of new loans fell to a 12-month low as refinancing activity continued to recede. Performance was flat in August amid a rise in stock market volatility and a steady decline in 10-year U.S. Treasury yields. In September, the asset class benefited from lessening macro stress, optimism surrounding the release of a tax plan by Congressional Republicans, continued equity market strength, and a firmer backdrop for the energy sector.

U.S. crude oil prices rebounded in the third quarter, fueled by unexpected strong demand, signs of ebbing U.S. production, and refinery disruptions resulting from Hurricane Harvey. The price for a barrel of West Texas Intermediate, the U.S. crude benchmark, ended the period at $51.67, representing a 10.5% advance for the quarter.

For the quarter overall, investors grappled with geopolitical risk, highlighted by heated rhetoric surrounding North Korea's nuclear program. In the United States, Hurricanes Harvey and Irma caused suffering and economic disruption in Texas and Florida, respectively. Despite these developments, investors focused on a broader macro landscape that revealed a rising trajectory, with second-quarter U.S. gross domestic product revised upward to 3.1% and a labor market that continued to register reasonably positive gains.

The 10-year Treasury yield ended the quarter about where it started, at 2.33%. The yield declined during August into early September amid heightened U.S.–North Korea tension. The yield moved higher during the remainder of September, however, as the Federal Reserve indicated that it still saw the potential for raising rates once more this year and three times in 2018.

At its mid-September policy meeting, the Fed left the target for short-term interest rates unchanged at a range of 1% to 1.25%. The central bank announced that it would begin in October to shrink its massive portfolio of Treasuries and agency mortgage-backed securities [MBS] that it accumulated after the 2008 financial crisis.

Within the loan market, the energy, utilities, and consumer products sectors generated the best returns. Conversely, retail, telecommunications, and housing were the weakest performers, with retail and telecom being the only cohorts to post negative returns. From a credit-quality perspective, lower-quality split B/CCC-rated loans delivered the best performance, as investors were willing to assume greater risk to access higher yields.

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

Generally speaking, we take a fairly conservative approach to credit risk. Consequently, looking back over the fund's history, during periods when lower-quality loans have led the market — as was the case this quarter — the fund has generated solid absolute returns but has tended to lag the benchmark.

At the sector/industry level, the fund benefited from an overweight allocation to energy, along with security selection in gaming, lodging & leisure, paper & packaging, and retail. There were no significant relative detractors, but selection in diversified media nicked the fund's return.

For investors who may be new to the fund, or bank loans in general, can you explain the LIBOR floor feature of loans?

Many corporations issue both bank loans and high-yield bonds. Normally, bank loans are secured by the issuer's assets, giving loans a senior position in the firm's capital structure, whereas high-yield bonds are subordinate to bank loans. Historically, when bankruptcy occurs, bank-loan investors have been repaid substantially more of their principal than holders of high-yield bonds or other debt instruments. The measurement of such repayments is called the "recovery rate."

The coupons, or stated interest rates, on bank loans are linked to the London Interbank Offered Rate [LIBOR] — a widely used benchmark for short-term lending among banks — and adjust higher or lower at frequent intervals. This feature can potentially make bank loans less subject to interest-rate risk versus longer-term investment-grade or high-yield bonds that carry fixed coupons.

Since the summer of 2016, LIBOR has been rising, mostly due to factors related to money-market reform. In early January 2017, three-month LIBOR reached 1%, the first time it achieved that level since 2009, and was at 1.3% at period-end.

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

We evaluate the bank-loan market through three lenses: fundamentals, valuation, and technicals — the latter meaning the balance of supply and demand. As of period-end, we have a positive fundamentals outlook and generally have a neutral view on valuation and technicals.

Looking at fundamentals, economic expansion in the United States, as well as abroad, and solid U.S. corporate earnings, have helped risk-based assets across the board, including bank loans. Recently — and for the first time since 2011 — companies in the S&P 500® Index posted two consecutive quarters of double-digit-percentage earnings growth from the year-earlier period, according to data provider FactSet.

Default trends are another factor in our favorable fundamentals outlook. The loan default rate has modestly declined in 2017, ending the period at 1.31%, while recovery rates have increased. Only one company defaulted in September, the third consecutive month with only one or no defaults. As a result, 2017's third quarter saw the lightest stretch of default activity since the second quarter of 2011.

Turning to valuation, as of August 31, the average discounted spread over LIBOR in the S&P/LSTA Leveraged Loan Index was about four percentage points, below where it began the year and also lower than the long-term average. Roughly 70% of the loans in the index were trading at or near par [face value]. In our view, these data portray a loan market where valuations are not overly attractive but also are not exceptionally rich.

We think it is possible that refinancing activity in the loan market may continue to slow over the balance of 2017. However, with a relatively high percentage of outstanding loans trading at par, there appears to be limited near-term capital appreciation potential. As a result, we think most of the fund's near-term return is likely to come from coupon income.

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. By contrast, we had a relatively negative view toward retail, due to weak earnings trends and longer-term concerns related to brick-and-mortar versus online sales. Consequently, we plan to maintain underweight exposure there. The fund also had lighter-than-benchmark exposure to technology, services, and transportation.

Putnam Floating Rate Income Fund (PFRYX)

Annualized total return performance as of 9/30/17

Class Y shares Inception 10/4/05	**Net asset value**	**S&P/LSTA Leveraged Loan Index (LLI)**
Last quarter	1.02%	1.02%
1 year	4.16	5.29
3 years	3.23	3.87
5 years	3.64	4.09
10 years	3.64	4.72
Life of fund	3.82	4.82

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.

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.

The views and opinions expressed are those of the portfolio managers as of September 30, 2017, 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 of the risk of default, 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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