Q4 2017 | Putnam Floating Rate Income Fund Q&A

Continued strength lifts loans to par valuations

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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 strong security selection in retail, along with favorable positioning in gaming, lodging & leisure. There were no major detractors, but positioning in technology and food & beverages nicked relative results.

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 fourth quarter of 2017?

Bank loans returned 1.10% for the fourth quarter, as measured by the S&P/LSTA Leveraged Loan Index, marking their eighth-straight quarterly gain. With this performance, loans outpaced both high-yield bonds and the broad investment-grade fixed-income market.

The asset class posted a solid gain in October, as investors refocused their attention on interest-rate risk, with U.S. Treasury yields continuing an upward move that began in September. Loan prices dipped and recovered in November, amid bond-price volatility and various sector-specific issues. Loans registered another gain in December, despite elevated prices and ongoing refinancing activity.

Within the index, the energy sector was one of the top performers for the quarter. Crude oil prices rose steadily during the period, bolstered by improving global demand, an agreement between the Organization of Petroleum Exporting Countries [OPEC] and Russia to extend supply cuts through 2018, and supply disruptions in Libya. By quarter-end, the price of oil reached $60.42 per barrel, its highest level since June 2015 and up from $51.67 at the end of the third quarter.

Improving economic growth and the continuation of a positive trend for corporate profits bolstered investor sentiment in the fourth quarter. U.S. gross domestic product [GDP] registered two consecutive quarters of 3% or better annualized growth in the second and third quarters of 2017. Consumer spending was solid overall, as was business investment, and exports grew, reflecting a strengthening global economy. The unemployment rate reached a 17-year low of 4.1%. A closely watched measure of corporate profits — after-tax profits, without inventory valuation and capital consumption adjustments — increased 9.8% compared with a year earlier. All told, we think these trends point to a steadily growing economy ahead of the $1.5 trillion tax cut that was approved by Congress in late December, with a portion of that amount likely to influence the economy this year.

The most recent data on U.S. inflation showed that the personal-consumption expenditures price index — the price gauge the Federal Reserve prefers — had risen at a 1.8% annual rate, still below the central bank's long-elusive 2% target. Despite the continuing trend of low inflation, the Fed hiked its benchmark rate by a quarter percentage point to a range of 1.25% to 1.5%, the fifth such increase in the past two years, citing indications of accelerating economic growth. The Fed also reiterated its forecast for raising rates potentially three times in 2018.

Gains were modest but broad-based across loan-market industry groups. Besides energy, automotive, broadcasting, and metals & mining notably outperformed the index. By contrast, consumer products and transportation lagged and were the only cohorts to post negative returns. From a credit-quality perspective, lower-quality loans outperformed the market amid positive sentiment. Higher-quality BB-rated loans also did well, finishing roughly in line with the market's return.

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 strong security selection in retail, along with favorable overall positioning in gaming, lodging & leisure. There were no major detractors, but lighter-than-benchmark exposure to the technology sector and positioning in food & beverages 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 1.7% 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 fundamental outlook and generally have a neutral view on valuation and technicals.

Looking at fundamentals, the U.S. economy continues to expand, aided by a reacceleration in global growth. We think corporate fundamentals — sales, earnings, cash flow, and debt management — are likely to remain strong, providing a supportive environment for risk-based assets, including bank loans.

Default trends are another factor in our favorable fundamental outlook. Default activity declined in 2017, registering its lowest annual total since 2013. Heavy default activity in commodity-related sectors over the prior two years, which accounted for nearly two-thirds of total volume in 2015 and 2016 combined, declined significantly. At the same time, non-commodity defaults increased moderately. At period-end, the loan default rate was 1.8%. We think the default rate may rise modestly in 2018, but believe it will remain 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.

Turning to valuation, as of December 31, the average discounted spread over LIBOR in the S&P/LSTA Leveraged Loan Index was about 4.2 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. 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.

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 12/31/17

Class Y shares Inception 10/4/05	**Net asset value**	**S&P/LSTA Leveraged Loan Index (LLI)**
Last quarter	1.05%	1.10%
1 year	3.54	4.11
3 years	3.77	4.43
5 years	3.54	4.02
10 years	3.78	4.85
Life of fund	3.83	4.81

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 December 31, 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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