Putnam INVESTMENTS

Q1 2017 | Putnam Floating Rate Income Fund Q&A

# Fund posts modestly positive results amid risk-driven environment

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***For the quarter, Putnam Floating Rate Income Fund trailed its benchmark, the S&P/LSTA Leveraged Loan Index.***

***Loan coupons adjusted upward during the period, providing the fund's investors with incrementally higher income.***

***If the Federal Reserve continues to increase short-term interest rates, and three-month LIBOR follows suit, we think bank-loan coupons are likely to continue rising.***

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

After ending 2016 on a strong note, bank loans registered more modest gains in January and February, as loan refinancing intensified and the rally in stocks and credit ebbed.

Loans came under pressure in March amid a selloff in high-yield bonds and weakening demand for floating-rate product. High-yield credit was buffeted by hawkish rhetoric from the Federal Reserve, a sharp decline in oil prices, rising stock market volatility, heavy new supply, and a failed effort by the U.S. House of Representatives to repeal the Affordable Care Act. Later in the month, however, oil prices rebounded to a three-week high amid signs of growing U.S. demand, a supply disruption in Libya, and speculation that the Organization of Petroleum Exporting Countries might extend its supply cuts into May. Against this backdrop, loans stabilized in late March as credit market conditions steadily improved.

Loan funds reported a ninth consecutive month of inflows in March. Year-to-date, net inflows totaled $12.7 billion compared with outflows of -$5.9 billion for the first three months of 2016.*

* Source: J.P. Morgan.

As expected, the Fed increased its target for short-term interest rates by a quarter percentage point to a range of 0.75% to 1% at its mid-March policy meeting. Fed Chair Janet Yellen expressed confidence in the economy and reaffirmed that the central bank may implement two more increases this year.

Gains were broad-based across industries, led by energy, broadcasting, and metals & mining. Conversely, retail, utilities, and food & beverages were the weakest performers. Retail was the only industry to post a negative return, as many store operators continued to struggle with declining sales at brick-and-mortar locations. From a credit-quality perspective, lower-quality loans delivered the best performance, reflecting continued investor appetite for risk.

**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. Historically, during periods when market gains are led by lower-quality securities — as was the case this period — the fund has generated solid absolute returns but has tended to lag the benchmark.

From a sector/industry perspective, the fund's relative performance benefited from overweight allocations to financials, gaming, lodging & leisure, and housing. On the downside, overall positioning in technology and services, along with an overweight in retail, worked against benchmark-relative performance.

**What is your current assessment of market fundamentals?**

We think fundamentals remain supportive. Fourth-quarter U.S. gross domestic product [GDP] was revised upward from a 1.9% to a 2.1% annual rate, according to the Commerce Department. This follows growth of 3.5% in the third quarter.

The government also reported that corporate profits grew at a 2.3% annual rate in the fourth quarter, down from 6.7% in the third quarter. The downtrend, however, was largely attributable to the impact of a nearly $5 billion settlement between the U.S. subsidiary of Volkswagen AG and U.S. federal and state governments for violation of environmental regulations. The Commerce Department also reported that a measure of after-tax corporate profits jumped 22.3% in the fourth quarter compared with a year earlier.

In our view, the Trump administration's pro-business agenda — reduced regulation, lower corporate tax rates, and increased infrastructure spending — may lead to accelerating economic growth as well as stronger revenue and earnings growth for high-yield companies. That said, with valuations of credit-sensitive bonds appearing elevated, any significant disappointments regarding actual policy implementation may result in periods of volatility.

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

Bank loans are typically priced on the basis of the three-month London Interbank Offered Rate [LIBOR], a widely used benchmark for short-term lending among banks. New bank loans are structured with a fixed spread, with the loan's coupon, or stated interest rate, consisting of the three-month LIBOR plus this spread.

A LIBOR floor is a feature of a loan's contract that establishes a fixed starting point for LIBOR. These floors were established to attract investors after the 2008 financial crisis, when LIBOR was at very low levels. If LIBOR rises above this contractual floor, the loan's yield will rise to reflect this increase in LIBOR. If LIBOR should fall, the loan's yield will not decline below the level of the floor.

Since the summer of 2016, LIBOR has been rising, mostly due to factors related to money market reform. In January 2017, the three-month LIBOR reached 1%, the first time it achieved that milestone level since 2009, and was at 1.06% at quarter-end. With roughly 90% of outstanding loans having a LIBOR floor of 1%, loan coupons adjusted upward during the period, providing the fund's investors with incrementally higher income.

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

If the Fed continues to increase short-term interest rates, and the three-month LIBOR follows suit, we think bank-loan coupons will continue to adjust higher and investor demand will likely remain strong. However, with an increasing percentage of outstanding loans trading at par [face value] or higher, and refinancing expected to continue at a robust rate, there appears to be limited near-term capital appreciation potential. As a result, we think most of the fund's return is likely to come from coupon income.

### How do you plan to position the fund in light of this outlook?

As of period-end, we had a relatively negative view toward retail, given weak earnings trends and longer-term issues related to brick-and-mortar versus online sales. Consequently, we plan to maintain underweight exposure there.

We are closely monitoring developments in health care. Headline risk has risen in this sector, due to policy uncertainty regarding the new administration's stance on drug pricing and whether the Affordable Care Act will be overhauled.

Within this environment, we will continue to position the fund with an emphasis 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 3/31/17

| **Class Y shares** Inception 10/4/05 | **Net asset value** | **S&P/LSTA Leveraged Loan Index (LLI)** |
|---|---|---|
| Last quarter | 0.70% | 1.16% |
| 1 year | 7.45 | 9.72 |
| 3 years | 2.76 | 3.57 |
| 5 years | 4.05 | 4.58 |
| 10 years | 3.50 | 4.55 |
| Life of fund | 3.83 | 4.86 |

Total expense ratio: 0.77%

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, 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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**Request a prospectus or summary prospectus from your financial representative or by calling 1-800-225-1581. The prospectus includes investment objectives, risks, fees, expenses, and other information that you should read and consider carefully before investing.**

Putnam Retail Management

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