Q4 2017 | Putnam Absolute Return Funds Q&A

Funds deliver positive returns amid supportive global economic backdrop

100 FUND AND 300 FUND

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500 FUND AND 700 FUND

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What was the investment environment like during the fourth quarter of 2017?

Improving economic growth and the continuation of a positive trend for corporate profits bolstered investor sentiment during the 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 yield on the benchmark 10-year U.S. Treasury stayed in a fairly tight range, ending the quarter at 2.40%. Rates rose modestly across the yield curve, with short-term yields rising more than longer-term yields in anticipation of a further increase by the Federal Reserve in the target for short-term rates. In December, 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. The central bank also reiterated its forecast for raising rates potentially three times in 2018.

After strengthening modestly early in the quarter, the U.S. dollar weakened in November and December on doubts that the Fed will be able to maintain its pace of rate increases this year in the face of low inflation. U.S. consumer prices have stayed stubbornly weak despite other signs of economic expansion. The most recent data on U.S. inflation showed that the personal-consumption expenditures price index — the Fed's preferred price gauge — had risen at a 1.8% annual rate, still below the central bank's long-elusive 2% target. Inflation remains low in the eurozone, Japan, and most other developed economies.

Overseas, the 19-country eurozone economy grew at an annualized rate of 2.4% in 2017's third quarter, a slowdown from the 2.6% growth rate recorded in the second quarter. Despite the third-quarter deceleration, the eurozone economy appears on course for its strongest year since 2007. Meanwhile, Japan's economy grew at an annualized pace of 1.4% in the July to September quarter, marking the country's seventh-straight quarter of growth — its longest streak since 2001.

For the first time in a decade, the world's major economies appear to be growing in sync. This parallel growth trend has been fueled by low interest rates and other stimulus measures by central banks, along with the gradual fading of crises that over the years ricocheted from the United States to Greece, Brazil, and elsewhere.

U.S. stocks continued to advance in the fourth quarter, with the bellwether S&P 500 Index gaining 6.64% and notching its ninth consecutive quarterly advance. Large-cap stocks outpaced their mid- and small-cap counterparts, with the Russell 1000 Index of large-company shares returning 6.59%. From a stylistic perspective, growth stocks outperformed value stocks, continuing a trend that began earlier this year.

Internationally, stocks in Japan and the emerging markets posted the best gains, outperforming European shares by a sizable margin, in U.S.-dollar terms.

In fixed income, eurozone and United Kingdom government bonds were among the top performers during the past three months with, for example, the Bloomberg Barclays Pan Euro Aggregate Bond Index returning 2.22% in U.S.-dollar terms. In U.S. corporate credit, investment-grade bonds modestly outpaced high-yield debt.

Before we discuss performance, would you summarize the funds' overall investment objectives and strategies?

Putnam Absolute Return 100 Fund and Absolute Return 300 Fund seek positive returns exceeding the return of Treasury bills by 1% and 3%, respectively, over a reasonable period of time, regardless of market conditions. The funds also employ strategies that may produce lower volatility over time. These two funds invest across the global fixed-income landscape, using modern risk management tools to help mitigate volatility.

Similarly, Putnam Absolute Return 500 Fund and Absolute Return 700 Fund seek positive returns exceeding the return of Treasury bills by approximately 5% and 7%, respectively, over a reasonable period of time, regardless of market conditions. The funds also employ strategies that may produce lower volatility over time. These two multi-asset funds seek to achieve risk-and-return characteristics by dynamically allocating assets using a combination of directional (or market sensitive) and non-directional (or market neutral) strategies. In addition, both the composition and total level of risk can be dynamically managed depending on market conditions and the prevailing opportunity set.

How did Absolute Return 100 Fund and 300 Fund perform, and what were the key contributors?

Both funds delivered modestly positive returns for the quarter. Corporate and mortgage credit contributed about equally in the 100 Fund, whereas mortgage credit was the clear leader in the 300 Fund.

Looking first at mortgage credit, positions in mezzanine commercial mortgage-backed securities [CMBS] added the most value. Our holdings of cash bonds performed well. Additionally, our long exposure to the BBB-rated tranche within the CMBX — an index that provides access to CMBS issued in a particular year — recovered in November and December following weakness in prior months.

An allocation to agency credit-risk transfer securities [CRTs] was another meaningful contributor. The sector rebounded from an August-to-September selloff driven by hurricanes in Texas and Florida, as investors concluded that initial damage fears were overblown. Furthermore, CRTs continued to benefit from strong overall demand, as investors continued to embrace the sector's relatively high yields backed by robust collateral and rising residential real estate prices.

In corporate credit, allocations to high-yield and investment-grade bonds were helped by a continuation of the positive trend in corporate earnings and an improving U.S. economy. The high-yield sector also continued to benefit from a benign default backdrop. Investments in high-yield debt were primarily concentrated in the 300 Fund.

Elsewhere, strategies targeting prepayment risk notably aided the performance of the 300 Fund. Our positions in reverse-mortgage interest-only securities continued to benefit from regulatory changes announced by the Department of Housing and Urban Development [HUD] in August. The market cheered the new regulatory backdrop, believing it would reduce the incentives for holders of such mortgages to refinance.

The U.S. government insures reverse mortgages under its Home Equity Conversion Mortgages [HECM] program. We focused on opportunities among HECM MBS that were issued by Ginnie Mae.

Investments in emerging-market debt were also additive for the 100 Fund, led by holdings of government bonds issued by Russia and Argentina.

What about detractors in the 100 and 300 Funds?

Currency strategies worked against the performance of the 300 fund during the fourth quarter. This was primarily the result of our overweight exposure to the weakening Norwegian krone, as well as our tactical positioning in the New Zealand dollar, which proved especially volatile during the period.

In the 100 Fund, our interest-rate and yield-curve strategies modestly hampered results. The fund's duration was near zero, meaning it had minimal sensitivity to interest-rate changes. This positioning dampened performance as rates rose slightly across all but the longest-maturity portion of the curve.

How did Absolute Return 500 Fund and 700 Fund perform, and what factors influenced their performance?

Both funds delivered positive returns for the quarter, with both directional and non-directional strategies adding value.

Within our directional strategies, long exposure to U.S. stocks was the biggest driver of performance, fueled by our allocation to low-volatility equities, as well as futures on the S&P 500 Index. Broad index exposure to commodities was also beneficial, particularly in October, when the funds increased their long exposure to this asset class. Exposure to high-yield corporate credit had a neutral effect on performance, while exposure to interest-rate risk was slightly negative.

Within non-directional strategies, we had good results from an equity mean-reversion strategy, which seeks to capitalize on short-term fluctuations in the S&P 500. Equity-selection alpha strategies — which are market-neutral trades designed to perform independently of global equity markets — also contributed. In particular, we had favorable results from quantitative long/short strategies in both the United States and globally.

The overall positive impact of our non-directional strategies was partially offset by weakness in a quantitative emerging-market long/short strategy, and a fundamentally driven long/short strategy in the United States. Similar to the 300 Fund, our currency overlay strategy, which uses a quantitative process to identify long and short opportunities across major global currencies, also detracted this period. That said, these pockets of non-directional weakness were not enough to meaningfully offset strong performance elsewhere.

What is your outlook for the coming months?

We believe the acceleration in global growth witnessed in 2017 will likely continue in 2018, but with significant changes in its components. We think U.S. GDP may strengthen somewhat from its recent level, but we also think growth in Europe and Japan may improve relative to the United States as 2018 unfolds. As a result, we think the euro and possibly the yen may strengthen versus the dollar later in the year. Meanwhile, the United Kingdom may be headed toward a softer version of Brexit as a consequence of recent developments in the country's efforts to separate from the European Union. Overall, we expect reasonably solid global growth, continued policy tightening by the Fed, relatively benign inflation, and a generally supportive environment for risk-driven assets. We also think bond yields may continue to drift higher over the course of 2018 as rate normalization continues.

In our view, the Fed will be a key focus of investor attention in 2018, especially during the first half, as a new chair takes office and new governors join the Federal Open Market Committee. While we don't anticipate significant policy changes under the new Fed chair, we do see the potential for miscommunication as the market adjusts to the tone and language of a new leader.

As we begin the new year, we're paying close attention to European sovereign bonds. At its latest policy meeting, the European Central Bank [ECB] indicated that it would continue its easy monetary policy in 2018. In our view, a key policy issue for the ECB early in 2018 will be the fact that the eurozone economy may continue to grow at a faster-than-forecast rate. If this occurs, inflation could begin to rise in the eurozone well before that happens in the United States or the United Kingdom. Increasing inflation could, in turn, lead to upward pressure on interest rates, which could affect not only European bonds, but other asset markets as well.

How do you plan to position the 100 Fund and 300 Fund?

We think prepayment risk remains attractive because relatively tight mortgage-lending standards may continue to curb refinancing activity. Within corporate credit, valuations are not as attractive as they were a year ago, but continue to look fair to us, in light of our positive outlook for corporate fundamentals, the U.S. economy, and default trends in the high-yield market. Within mortgage credit, we think CMBS could benefit from employment growth, low interest rates, and a continuation of the current economic expansion. While we expect some degree of losses related to regional malls, we're also encouraged by the fact that many malls are attempting to repurpose their space to attract new types of tenants.

What about the 500 Fund and 700 Fund?

We continue to favor non-directional risk over directional risk. Against the backdrop of what we consider to be a complicated global economic picture, we think we may be able to add the most value with non-directional strategies. Within directional risk, we will continue to take a tactical approach, adjusting the funds' exposure across various markets as conditions warrant.

We see strong but competing forces within both equity and credit markets, where stretched valuations and tighter spreads appear to be balanced by continued momentum and a tailwind from tax reform.

Entering 2018, we believe energy prices could exhibit increased volatility. However, it is unclear to us whether they will move higher or lower. Global demand is outstripping supply which, among other factors, favors a bullish scenario. Conversely, higher prices could lead to production increasing beyond current expectations, which would likely keep a lid on prices.

Within this environment, in our non-directional strategies, we will continue to pursue opportunities across a variety of asset classes and available strategies. As of quarter-end, equity selection alpha accounts for the largest portion of non-directional risk, though we plan to continue focusing on less-rate-sensitive fixed-income sectors, such as MBS, as well as other sources of return.

Putnam Absolute Return Funds

Fund symbols

	100 Fund	300 Fund	500 Fund	700 Fund
Class A	PARTX	PTRNX	PJMDX	PDMAX
Class B	PARPX	PTRBX	PJMBX	PDMBX
Class C	PARQX	PTRGX	PJMCX	PDMCX
Class M	PARZX	PZARX	PJMMX	PDMMX
Class R	PRARX	PTRKX	PJMRX	PDMRX
Class Y	PARYX	PYTRX	PJMYX	PDMYX

Annualized total return performance as of 12/31/17

Class Y shares Inception 12/23/08	100 Fund Net asset value	300 Fund Net asset value	500 Fund Net asset value	700 Fund Net asset value	ICE BofAML U.S. Treasury Bill Index
Last quarter	0.42%	0.60%	2.00%	2.71%	0.25%
1 year	3.47	5.53	7.46	10.09	0.81
3 years	1.88	1.97	2.77	3.77	0.42
5 years	1.72	2.46	3.45	4.75	0.28
Life of fund	1.73	2.82	4.23	5.57	0.24
Total expense ratio	0.38	0.45	0.85	0.96	—
What you pay*	0.38	0.45	0.82	0.96	—

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. For a portion of the periods, the funds 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.

* "What you pay" reflects Putnam Management's decision to contractually limit expenses for the Absolute Return 500 Fund through 2/28/18.

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The funds are not intended to outperform stocks and bonds during strong market rallies.

Consider these risks before investing: Our allocation of assets among permitted asset categories may hurt performance. The prices of stocks and bonds in the funds' portfolio may fall or fail to rise over extended periods of time for a variety of reasons, including both general financial market conditions and factors related to a specific issuer or industry. Our active trading strategy may lose money or not earn a return sufficient to cover associated trading and other costs. Our use of leverage obtained through derivatives increases these risks by increasing investment exposure. 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 ongoing fees and expenses. Lower-rated bonds may offer higher yields in return for more risk. Funds that invest in government securities are not guaranteed. Mortgage-backed securities are subject to prepayment risk. International investing involves certain risks, such as currency fluctuations, economic instability, and political developments. Additional risks may be associated with emerging-market securities, including illiquidity and volatility. Our use of derivatives may increase these risks by increasing investment exposure (which may be considered leverage) or, in the case of many over-the-counter instruments, because of the potential inability to terminate or sell derivatives positions and the potential failure of the other party to the instrument to meet its obligations. The funds may not achieve their goal, and they are not intended to be a complete investment program. The funds' effort to produce lower-volatility returns may not be successful and may make it more difficult at times for the funds to achieve their targeted return. In addition, under certain market conditions, the funds may accept greater volatility than would typically be the case, in order to seek their targeted return. **For the 500 Fund and 700 Fund, these risks also apply:** REITs involve the risks of real estate investing, including declining property values. Commodities involve the risks of changes in market, political, regulatory, and natural conditions. Additional risks are listed in the funds' prospectus. You can lose money by investing in the funds.

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