Q3 2017 | Putnam Absolute Return Funds Q&A

Funds deliver positive returns, led by equity-focused strategies

100 FUND AND 300 FUND

D. William Kohli
CIO, Fixed Income
Industry since 1988

Albert Chan, CFA
Portfolio Manager
Industry since 2002

Michael V. Salm
Co-Head of Fixed Income
Industry since 1989

Paul D. Scanlon, CFA
Co-Head of Fixed Income
Industry since 1986

500 FUND AND 700 FUND

James A. Fetch
Co-Head, GAA
Industry since 1994

Robert J. Kea, CFA
Co-Head, GAA
Industry since 1988

Robert J. Schoen
CIO, GAA
Industry since 1990

Jason R. Vaillancourt, CFA
Co-Head, GAA
Industry since 1993

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

The trend of elevated risk appetite continued during the third quarter.

Globally, 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 benchmark 10-year U.S. Treasury yield ended the quarter at 2.33%, slightly above where it started. 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, in October, it would begin to shrink its massive portfolio of Treasuries and agency mortgage-backed securities that it accumulated after the 2008 financial crisis.

Overseas, second-quarter growth in the 19-nation eurozone came in at a 2.6% annual rate, a faster pace than the European Central Bank [ECB] had expected at the beginning of the year. The eurozone's strength has been one of the positive surprises for the global economy this year, as it outpaced the United States in the first quarter and accelerated further in the three months ended June 30, 2017.

ECB monetary policy remains supportive, but an announcement by ECB President Mario Draghi signaled that the bank could announce a plan in October to gradually end its program of bond purchases. However, Mr. Draghi also warned that the bank's next steps would partly depend on the strength of the euro, which has surged by about 12% against the U.S. dollar since the beginning of the year.

U.S. stocks continued to advance in the third quarter, with the bellwether S&P 500 Index gaining 4.48% and notching its eighth consecutive quarterly advance. Small-cap stocks outpaced their large- and mid-cap counterparts, with the Russell 2000 Index of smaller-company shares returning 5.67%. From a stylistic perspective, growth stocks outperformed value stocks, continuing a trend that began earlier this year.

Emerging-market [EM] stocks, as measured by the MSCI Emerging Market Index [ND], rose 6.60%, and as of September 30, were ahead 25% on a year-to-date basis. The EM rally reflects faster earnings growth, a weaker dollar, and easy global monetary policies that make riskier investments more attractive. Meanwhile, foreign developed-market stocks gained 5.40%.

Emerging markets were also among the top performers in fixed-income markets, with the JPMorgan Emerging Markets Bond Index returning 2.63%. In U.S. corporate credit, high-yield bonds outpaced investment-grade corporates as yield spreads continued to tighten.

U.S. crude oil prices rebounded in the third quarter, fueled by unexpected strong demand for crude, 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.

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. Mortgage-credit strategies were the top contributor in the 100 Fund, whereas active currency strategies provided the biggest boost to the 300 Fund.

Looking at the 100 Fund, our holdings of mezzanine commercial mortgage-backed securities [CMBS] were among the top contributors. Additionally, within non-agency residential mortgage-backed securities [RMBS], positions in pay-option adjustable-rate mortgages benefited from a generally favorable risk environment, as well as the fact that there was no new supply of these bonds coming to market.

Positions in investment-grade corporate bonds and EM debt contributed about equally to the 100 Fund. Corporate credit spreads continued to grind tighter, aided by strong investor demand for relatively high-yielding securities, continued strength in corporate earnings, and a generally healthy U.S. economic backdrop. In EM, positions in Brazil, Argentina, Russia, and Mexico modestly aided performance. Argentine bonds benefited from a primary vote ahead of congressional elections in October that gave a boost to the market-friendly agenda championed by the country's president. Positions in Brazil rallied when the country's senate passed a labor reform bill in July.

In the 300 Fund, positive results from our currency strategies were driven by long positions in the euro and Swedish krona, both of which strengthened by roughly 3% versus the U.S. dollar during the quarter.

Corporate and mortgage credit also meaningfully contributed to the 300 Fund. Within corporate credit, both investment-grade and high-yield bonds aided performance. High-yield credit benefited from the same dynamics as investment-grade bonds, but was also helped by a benign default environment.

Investments in EM debt were also additive for the 300 Fund.

What about detractors in the 100 and 300 Funds?

Our interest-rate and yield-curve strategies were the primary detractors in both funds. Each fund had a duration that was near zero, meaning they had minimal sensitivity to interest-rate changes. This positioning worked against performance — slightly in the 100 Fund but somewhat more so in the 300 Fund — as rates rose modestly across the yield curve.

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

The 500 Fund and the 700 Fund both delivered strong returns for the quarter, with our non-directional strategies fueling performance. Directional strategies — where we positioned the funds to be long in equity and credit risk — also helped, as did directional positioning in interest-rate and inflation risk.

Within non-directional strategies, equity-selection alpha strategies — which are market-neutral trades designed to perform independently of global equity markets — contributed the most. In particular, we had favorable results from our forensic accounting trade, where we established short positions in companies that use aggressive accounting practices while simultaneously hedging out market risk. Our quantitative equity research strategy in the United States — where we utilized quantitative models to develop a long/short portfolio — also bolstered results. By contrast, an emerging-market strategy underperformed and slightly detracted from our equity-selection alpha strategies.

Elsewhere, a quantitative global equity long/short strategy provided a further boost, as did active currency and commodity alpha strategies. Within commodity alpha, we utilized two structured commodity trades in an effort to capture roll yield and other excess return factors across various commodity sectors. Both trades aided performance for the quarter. Lastly, an equity mean-reversion strategy, which seeks to capitalize on short-term moves in the stock market, also aided performance.

What is your outlook for the coming months?

The Fed had signaled for months that it was planning to begin reducing its $4.5 trillion bond portfolio, and in September announced that it would start the process in October. The Fed's plan is to allow a specific amount of securities to mature each month (or pay down, in the case of MBS): $6 billion in Treasuries and $4 billion in MBS. It would then allow the amount of maturities to increase each quarter, ultimately reaching a maximum of $30 billion per month for Treasuries and $20 billion per month for agency MBS. We expect that the Fed will reduce its holdings in a gradual and predictable manner in an effort to avoid interest-rate spikes or other market strains.

The central bank stopped adding to its investments more than three years ago, but it has been reinvesting the proceeds of maturing bonds to keep its holdings steady. These reinvestments have helped keep a lid on long-term interest rates, and letting securities mature without reinvesting could put upward pressure on rates. That said, we think the incremental nature of the plan suggests that rate volatility may be limited, at least initially.

Turning to bond yields, we think yields are too low given generally favorable global economic conditions. Although we don't believe yields are likely to rise significantly this year, partly due to strong global demand for U.S. bonds, we do think they'll be higher by the end of 2018. There are a lot of unknowns: potentially significant changes to the Fed's Board of Governors in 2018; the timing of when the ECB will begin to taper its bond-purchase program; tax reform in the United States; tighter monetary policy in other countries, such as Canada and the United Kingdom; and the ongoing potential for geopolitical flare-ups. So, while there are a variety of cross-currents that could impact the trajectory of bond yields both in the United States and overseas, we think the overall trend will be for yields to rise next year.

In terms of positioning the 100 Fund and the 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.

How do you plan to position the 500 Fund and 700 Fund during the final months of 2017?

We continue to favor non-directional risk over directional risk. This view is predicated on what we perceive as a complicated global economic picture. Within directional risk, we will continue to take a tactical approach across various markets.

Within the U.S. equity market, we believe it will likely take some time for the crosscurrents of domestic political and economic forces to sort themselves out, making flexibility important. 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.

Entering the fourth quarter, we are most constructive on commodities. Our bullish quantitative model, coupled with data suggesting that the global economy may be firing on all cylinders, lead us to believe that the environment for commodity prices may be supportive.

Against this backdrop, in our non-directional strategies, we will continue to pursue opportunities in equity selection alpha while also focusing on less rate-sensitive fixed-income sectors, such as MBS.

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 9/30/17

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	BofA Merrill Lynch U.S. Treasury Bill Index
Last quarter	0.99%	0.80%	2.06%	2.86%	0.26%
1 year	3.78	6.47	5.55	8.03	0.64
3 years	1.66	1.49	2.68	3.67	0.34
5 years	1.76	2.66	2.90	3.98	0.24
Life of fund	1.73	2.84	4.12	5.41	0.22
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.

The Bank of America (BofA) Merrill Lynch U.S. Treasury Bill Index is an unmanaged index that tracks the performance of U.S. dollar-denominated U.S. Treasury bills publicly issued in the U.S. domestic market. Qualifying securities must have a remaining term of at least one month to final maturity and a minimum amount outstanding of $1 billion. You cannot invest directly in an index. The index data referenced herein is the property of Merrill Lynch, Pierce, Fenner & Smith Incorporated ("BofAML") and/or its licensors and has been licensed for use by Putnam Investments. BofAML and its licensors accept no liability in connection with its use. See prospectus for a full copy of the Disclaimer.

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

Consider these risks before investing: Allocation of assets among asset classes may hurt performance. Bond prices 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. These factors may also lead to periods of high volatility and reduced liquidity in the bond markets. 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. 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 and the risk that they may increase in value less when interest rates decline and decline in value more when interest rates rise. International investing involves currency, economic, and political risks. Emerging-market securities have illiquidity and volatility risks. The fund may not achieve its goal, and it is not intended to be a complete investment program. 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. The funds' efforts 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. Under certain market conditions, the funds may accept greater-than-typical volatility to seek their targeted return. You can lose money by investing in the funds. The funds' prospectus lists additional risks. **For the 500 Fund and 700 Fund, these risks also apply:** Growth stocks may be more susceptible to earnings disappointments, and value stocks may fail to rebound. Our alpha 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.

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Putnam Investments | One Post Office Square | Boston, MA 02109 | putnam.com

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