Q1 2017 | Putnam Absolute Return Funds Q&A

Diversified strategies help funds advance in the first quarter

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 first quarter of 2017?

The environment was generally supportive for riskier assets. During January and February, investors were optimistic about the potential for tax cuts and increases in infrastructure and defense spending under the Trump administration. Later in the quarter, however, a failed effort to repeal the Affordable Care Act triggered uncertainty about the administration's ability to get its tax-reform and fiscal-stimulus plans passed by Congress.

Economic data in both the United States and globally were positive overall. In particular, 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. In February, the Federal Reserve's preferred inflation gauge, the Personal Consumption Expenditures Price Index, rose 2.1% from a year earlier, the first time inflation exceeded the central bank's target in nearly five years. The jobless rate in the 19-country eurozone declined to 9.5% in February, the lowest level since 2009.

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. The benchmark 10-year Treasury yield rose from late February through mid-March in anticipation of the Fed's move, and then fell, ending the quarter at 2.39%, slightly below where it began the year.

It was a good start to the year for equities and other risk assets. This was true for both domestic and international risk assets, including those in developed and emerging markets. A handful of catalysts drove this robust performance, but it was propelled mainly by the solid upward trajectory of economic growth across the globe. In the United States, gross domestic product continued its steady expansion, with equities rallying in tandem as favorable consumer and business sentiment coalesced around expectations for the pro-growth strategies of a new administration in the White House. Stronger economic growth internationally— within developed-country markets in the eurozone and Japan, as well as in pockets of the emerging markets — also contributed to solid performance among global risk assets. In the final month of the period, however, amid political and policy uncertainties in the United States, the post-election equity rally seemed to lose some of its steam.

The S&P 500 Index, a bellwether for the U.S. stock market, gained 6.07% in the first quarter of 2017. The MSCI EAFE Index [ND], which measures the broad performance of stocks in the developed markets of the world, advanced 7.25% during the period, while emerging-market stocks, as represented by the MSCI Emerging Market Index [ND], rose 11.44%. In the credit-sensitive fixed-income sector, as defined by the performance of high-yield bonds, results fluctuated late in the period, but they ended higher, with the JPMorgan Developed High-Yield Index returning roughly 2.59% for the quarter.

After reaching a 14-year high in early January, the U.S. dollar declined by 3.5% for the quarter, as investors grew more cautious on the currency amid uncertainties surrounding the Trump administration's policy platform.

U.S. crude oil prices stayed above $54 per barrel for most of the quarter, but fell in early March after weekly data showed a record inventory buildup. This concern eased somewhat later in the month, and oil prices rose to end the period at $50.60 on the New York Mercantile Exchange.

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 risk.

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 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 positive returns, led by our mortgage-credit strategies. Holdings of mezzanine commercial mortgage-backed securities [CMBS] and non-agency residential mortgage-backed securities [RMBS] contributed about equally.

Early in the period, our positions in CMBS that were issued before the 2008 financial crisis performed particularly well. However, gains from the sector were pared in February when headlines concerning retail store closures prompted some investors to express a bearish view on certain parts of the CMBS market due to the sector's exposure to retail property prices. Although we agree that retailers face challenges amid evolving shopper preferences and a shift from traditional brick-and-mortar to online commerce, we believe the CMBS held by the funds have enough credit protection to withstand the changes that are occurring in retail.

Within non-agency RMBS, our investments in agency credit risk-transfer securities [CRTs] performed well, as did pay-option adjustable-rate mortgage-backed securities [pay-option ARMs]. A combination of relatively high yields and high-quality collateral continued to attract investors to the growing CRT market. Furthermore, CRTs provided investors with a productive alternative to deploy their capital as other parts of the non-agency RMBS market continued to shrink. Pay-option ARMs benefited from the generally favorable risk environment during the period, as well as the fact that there was no new supply of these bonds coming to market.

A meaningful allocation to investment-grade corporate bonds provided a further boost to results, despite modest spread widening in March [bond prices declined as yield spreads widened]. After a solid 2016, the sector continued to post positive returns, as the search for yield continued throughout the quarter. Optimistic sentiment toward the asset class was fueled by investor expectations that economic growth could potentially accelerate if the Trump administration is successful at implementing tax cuts and more-robust fiscal policy. Relatively stable global oil prices also provided a tailwind.

Did the 100 and 300 Funds differ in terms of any strategies?

Yes. Our interest-rate and yield-curve strategies, and our active currency positioning, contributed in the 300 Fund only.

Our global "term structure" strategies benefited from our non-U.S. positioning. We continued our efforts to de-emphasize interest-rate risk by keeping the portfolio's duration — a key measure of interest-rate sensitivity — below zero, mainly in Europe. This strategy proved advantageous as rates rose in Europe, particularly in the United Kingdom. Meanwhile, we kept the fund's U.S. duration near zero during the quarter.

As for our active currency strategies, the U.S. dollar weakened versus all other major developed-market currencies during the quarter. As a result, our long exposures to the strengthening Australian dollar, Swedish krona, and Mexican peso aided the fund's return. By contrast, unfavorable short positions in the Japanese yen and South Korean won partially offset the overall positive impact of our currency positioning.

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

The 500 Fund and the 700 Fund both delivered positive returns for the quarter. Two major factors drove those results. First was our directional equity exposure, where we positioned the funds to be long in equity risk. Given the strength in equity markets, this exposure delivered positive returns. The funds also benefited, albeit to a lesser extent, from directional strategies in each of the other asset classes, including credit risk and rate risk, where we maintained modest exposures, and commodities, where we had short exposures.

Non-directional strategies provided a greater share of the funds' performance. Favorable equity-selection alpha strategies, which are designed to perform independently of global equity markets, made a solid, broad-based contribution to the funds' returns. In particular, the funds had good results from our fundamental U.S. equity research strategy, where we take advantage of the work of Putnam's fundamental equity analysts to put together a long/short portfolio of their best ideas. The funds also benefited from some of the quantitative stock selection methodologies that we use in our Global Asset Allocation group, with notable results among emerging-market stocks. Alternative beta strategies made meaningful contributions as well.

On the downside, the funds experienced some weakness in our fundamental forensic accounting trade, where we seek to add value by establishing short positions in companies that use aggressive accounting practices. This strategy has often helped performance, but it fell short during the reporting period.

What is your outlook for the coming months?

As we look at the world today, we see economic activity picking up and inflation levels beginning to rise. Higher commodity prices appear to be working their way into final prices, which is leading to fairly persistent pricing pressures in the United States and elsewhere. In our view, global economies appear to be normalizing, and we think this is particularly true in the United States. Given this normalization, we think the level of interest rates remains too low.

Within this environment, we think the Fed's tone has changed somewhat. For some time now, the central bank has emphasized that its policy was data-dependent — particularly data related to employment and inflation levels. After years of employing stimulative monetary policy in an effort to ward off deflation, the Fed has now shifted its focus to inflation. This new phase of monetary policy is driven by a central bank that is becoming more concerned with the possibility that the economy could outperform forecasts. Consequently, we do expect the Fed to increase rates at least twice more this year, and these increases could occur sooner than the market is currently forecasting.

We are also monitoring developments that would signal the possible spread of global populism, such as the outcome of the presidential election in France. If the populist candidate there were to win, it could spark volatility as the market attempts to calibrate the effects of another populist president leading a major global economy.

In terms of positioning the 100 Fund and the 300 Fund, our non-U.S., quantitatively driven, negative-duration strategies have moved the total duration of the portfolios close to zero. We also extended our strategy of seeking to capitalize on potentially steeper global yield curves. We think this overall positioning could benefit the funds if interest rates continue to trend higher in 2017.

We plan to continue seeking opportunities in corporate and mortgage credit that we believe offer relative value. Within those market areas, we continue to have a constructive outlook for both investment-grade and high-yield bonds, based on what we think is a generally supportive fundamental and technical backdrop for corporate credit. We think commercial mortgage-backed securities may also continue to offer attractive spreads from a relative value standpoint.

How do you plan to position the 500 Fund and 700 Fund as we move deeper into 2017?

Currently, the funds favor non-directional risk over directional risk. This view is predicated on what we perceive as a complicated global economic picture at the moment.

Within the U.S. equity space, we believe it will likely take some time for the crosscurrents of domestic political and economic forces to sort themselves out. The post-election rally in equities may need further evidence of political progress in corporate tax reform, deregulation, and infrastructure build-out to regain its previous momentum. Internationally, we will keep a close watch on some of the important upcoming elections in Europe, as well as the "Brexit" negotiations between the United Kingdom and the European Union, with the expectation that there may well be some volatility surrounding those events.

The Fed has telegraphed its intentions to continue raising short-term U.S. interest rates to combat the likelihood of inflation if global economic growth continues, which will likely depress U.S. bond prices. Meanwhile, central banks in most other parts of the developed world continue to hold interest rates at historical low levels. How the markets digest that divergence in interest-rate policy will help determine our future portfolio positioning decisions.

Given these uncertainties, we expect to remain basically neutral in our directional asset allocation strategies and will try to add value through our non-directional strategies.

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 3/31/17

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	**BofA Merrill Lynch U.S. Treasury Bill Index**
Last quarter	1.62%	2.61%	2.40%	3.24%	0.11%
1 year	5.06	8.13	4.72	7.57	0.37
3 years	1.42	1.09	2.20	3.09	0.20
5 years	1.60	2.39	2.80	3.77	0.16
Life of fund	1.67	2.73	4.02	5.27	0.18
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 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.

* "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 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. All performance and economic information is historical and is not indicative of future results.

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 fund's effort to produce lower-volatility returns may not be successful and may make it more difficult at times for the fund to achieve its targeted return. Under certain market conditions, the fund may accept greater-than-typical volatility to seek its targeted return. You can lose money by investing in the fund. The fund's 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.

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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