Q2 2020 | Putnam Ultra Short Duration Income Fund Q&A

Bond markets show signs of stabilizing

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

Joanne M. Driscoll, CFA
Portfolio Manager
Industry since 1992

Emily E. Shanks
Portfolio Manager
Industry since 1999

Michael J. Lima, CFA
Portfolio Manager
Industry since 1997

Bond markets held up well during the second quarter, supported by Fed programs.

Corporate credit was the main contributor to fund performance as spreads tightened dramatically.

We believe returns on short-term securities will remain attractive for conservative investors or those seeking safe havens.

How were market conditions in the second quarter?

Global financial markets proved to be surprisingly resilient during the second quarter. The coronavirus pandemic and the collapse in oil prices had sent equity and fixed-income markets into a tailspin during the first few months of the year. Since their lows in March, the S&P 500 Index, a broad measure of stocks, rose 20.54% and the MSCI World Index (ND) gained 19.36% during the second quarter. The market's resilience has also benefited bondholders. The Bloomberg Barclays U.S. Aggregate Bond Index gained 2.90% during the quarter. The ICE BofA 1–3 Year U.S. Corporate Index advanced 4.39% for the period.

Investors, however, are bracing for a global recession and a second wave of the coronavirus outbreak. The Fed purchase program and a flight-to-quality trade have pushed the yields on U.S. Treasuries lower. The yield on the 10-year Treasury note ended the quarter at 0.66% compared with 0.70% on March 31. The market for high-yield and investment-grade corporate bonds recovered as spreads, or the risk premiums investors demand to hold these securities over U.S. Treasuries, narrowed during the period.

The Fed cut interest rates to near zero in mid-March, and unleashed a torrent of bond-buying programs to help stabilize the markets. These actions have increased liquidity in the bond markets and, in turn, stabilized spreads. The U.S. Congress has also pumped trillions of stimulus dollars into the economy. Central banks across Europe, Asia, and other regions also rolled out COVID-19 stimulus measures.

How did the fund perform? What were the drivers of performance during the quarter?

The fund outperformed its benchmark, the ICE BofA U.S. Treasury Bill Index, during the period. The fund rose 2.36% versus a gain of 0.02% for the benchmark index for the three months ended June 30, 2020.

Corporate credit was the main contributor to the fund's performance as spreads tightened dramatically during the quarter. The fund is primarily invested in investment-grade corporate bonds and commercial paper [CP], so corporate spread movements tend to have the largest impact on the fund's performance. The spread on the Bloomberg Barclays 1–3 Year Corporate Index tightened by 188 basis points during the quarter, as spreads retraced most of the widening that took place in March. Meanwhile, the three-month London Interbank Offered Rate [LIBOR] ended the quarter at 0.30%, 115 bps lower than at the end of March.

The snapback in corporate credit was fueled by government stimulus, both fiscal and monetary, along with hopes of a sharp economic recovery as businesses began to reopen across the country and globe. The multitude of facilities established by the Federal Reserve kicked into gear as asset purchases began across a variety of sectors.

In addition, the fund's allocation to securitized sectors like non-agency residential mortgage-backed securities [RMBS] contributed to performance, as spreads in the sector retraced much of the widening that took place in March. We limit our allocation to securitized sectors to a maximum of 10% of the portfolio. Finally, positive duration positioning proved beneficial as U.S. rates remained range-bound, ending the quarter in close proximity to where they began.

What is your near-term outlook for fixed-income markets?

The second quarter saw a massive reversal in both market sentiment and price levels across asset classes. As the quarter came to a close, coronavirus cases began to reaccelerate, particularly in parts of the country that were first to reopen. As a result, other plans to reopen parts of the economy have been put on hold. It remains to be seen if any of the phased openings will need to be rolled back. Although the markets seem to be shrugging off this concern, significant uncertainty remains. As we head into the second half of 2020, the coronavirus will continue to dominate headlines. Investors will be focused on second-quarter earnings to determine the full impact on corporate balance sheets.

Despite uncertainty surrounding the pandemic, Putnam's fixed income team has a positive outlook on the fixed income markets. The Fed continues to understand the importance of the funding markets to the broader fixed-income landscape, and we are pleased with their ongoing response to stem the liquidity-driven pressures. We believe the Fed's facilities, including the money market liquidity facility, the commercial paper funding facility, and the corporate credit facilities, will continue to serve as a backstop for the financial markets. Overall, we believe the low utilization of the Fed facilities so far is an indicator of a relatively healthy market environment. Lastly, we expect short-term interest rates to remain near record lows this year because the Fed has indicated no desire to raise or cut rates for the foreseeable future.

What are the fund's strategies going forward?

From a strategy perspective, we made several decisions in the second quarter that had a positive effect on the fund's performance. We are confident about the fund's positioning as we head into the third quarter. The fund is targeting a duration of 0.30–0.35 years, approximately a tenth of a year longer than earlier in 2020. We also increased our allocation to fixed-rate corporates, particularly 1- to 3-year maturities, to lock in yield and add duration. Additionally, we are maintaining a high balance of short-maturity commercial paper for liquidity, although low yields in the very front end of the curve remain a challenge.

Furthermore, we continue to structure the portfolio with a barbell approach, emphasizing positions at separate points on the yield curve: investing in lower-tier investment-grade securities [BBB or equivalent] maturing in 1 year or less and in upper-tier investment-grade securities [A or AA rated] maturing in a range of 1 and 3.5 years. Despite ongoing changes in the market environment, capital preservation remains the primary objective of the fund.

Putnam Ultra Short Duration Income Fund (PSDYX)

Annualized total return performance as of 6/30/20

Class Y shares Inception 10/17/11	**Net asset value**	**ICE BofA U.S. Treasury Bill Index**
Last quarter	2.36%	0.02%
1 year	2.18	1.71
3 years	2.17	1.80
5 years	1.69	1.22
Life of fund	1.27	0.74

Total expense ratio: 0.38%

What you pay: 0.30%

Returns for periods of less than one year are not annualized.

"What you pay" reflects Putnam Management's decision to contractually limit expenses through 11/30/20.

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, 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.

LIBOR, the "London Interbank Offered Rate," is the rate at which banks lend to each other on the London interbank market for terms ranging from overnight to one year.

The Bloomberg Barclays U.S. 1–3 Year Corporate Bond Index is an unmanaged index that tracks the performance of U.S. dollar-denominated, investment-grade, fixed-rate, taxable corporate bonds with 1 to 3 year maturities.

The Bloomberg Barclays U.S. Aggregate Bond Index is an unmanaged index of U.S. investment-grade fixed-income securities.

The MSCI World Index (ND) is an unmanaged index of equity securities from developed countries.

The S&P 500 Index is an unmanaged index of common stock performance.

The ICE BofA 1–3 year U.S. Corporate Index is an unmanaged index of U.S. investment-grade corporate debt with a remaining term to maturity of less than 3 years.

The ICE BofA 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.

ICE Data Indices, LLC (ICE BofA), used with permission. ICE BofA permits use of the ICE BofA indices and related data on an "as is" basis; makes no warranties regarding same; does not guarantee the suitability, quality, accuracy, timeliness, and/or completeness of the ICE BofA indices or any data included in, related to, or derived therefrom; assumes no liability in connection with the use of the foregoing; and does not sponsor, endorse, or recommend Putnam Investments, or any of its products or services.

Duration measures the sensitivity of bond prices to interest-rate changes. A negative duration indicates that a security or fund may be poised to increase in value when interest rates increase.

For informational purposes only. Not an investment recommendation.

The views and opinions expressed are those of the portfolio managers of Putnam Ultra Short Duration Income Fund as of June 30, 2020. They are subject to change with market conditions and are not meant as investment advice.

Consider these risks before investing: Putnam Ultra Short Duration Income Fund is not a money market fund. The effects of inflation may erode the value of your investment over time. Funds that invest in government securities are not guaranteed. Mortgage-backed investments, unlike traditional debt investments, are also subject to prepayment risk, which means that they may increase in value less than other bonds when interest rates decline and decline in value more than other bonds when interest rates rise. The fund may have to invest the proceeds from prepaid investments, including mortgage-backed investments, in other investments with less attractive terms and yields. The value of investments in the fund's portfolio may fall or fail to rise over extended periods of time for a variety of reasons, including general economic, political, or financial market conditions; investor sentiment and market perceptions; government actions; geopolitical events or changes; and factors related to a specific issuer, geography, industry, or sector. These and other factors may lead to increased volatility and reduced liquidity in the fund's portfolio holdings. 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 generally greater for longer-term bonds, and credit risk is generally greater for below-investment-grade bonds. Credit risk is generally greater for debt not backed by the full faith and credit of the U.S. government. 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. Unlike bonds, funds that invest in bonds have fees and expenses. Our investment techniques, analyses, and judgments may not produce the outcome we intend. The investments we select for the fund may not perform as well as other securities that we do not select for the fund. We, or the fund's other service providers, may experience disruptions or operating errors that could have a negative effect on the fund. You can lose money by investing in the fund.

A world of investing.®

Putnam INVESTMENTS

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

Putnam Investments | 100 Federal Street | Boston, MA 02110 | putnam.com

TL736 322007 7/20