Q2 2019 | Putnam Ultra Short Duration Income Fund Q&A

Yields and low volatility boost short-term debt

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The Fed is likely to cut interest rates in the second half of 2019.

The 10-year U.S. Treasury yield tumbles below 2%.

Short-term bonds are an attractive option for investors seeking low volatility.

Not FDIC insured | May lose value | No bank guarantee

What was the market environment during the second quarter of 2019?

Global financial markets were generally positive during the second quarter. Investor appetite for risk assets, such as stocks, has ebbed and flowed because of the U.S.–China trade rift and growing fears that the dispute would accelerate a global economic slowdown. At the Group of 20 meeting in June, President Trump and Chinese President Xi Jinping made headway on stabilizing tariffs as they continue to work on long-term trade issues. Markets staged a relief rally after the trade truce and when the Federal Reserve indicated it could lower interest rates.

The Fed held interest rates steady in June but signaled a possible cut if the economic outlook doesn't improve. The outlook for U.S. growth remains mixed under the weight of the Trump administration's trade rifts, economic slowdowns in Europe and China, and fading stimulus from the tax cuts of 2017. Still, unemployment lingers at multi-decade lows, inflation remains anchored, and the likelihood of a recession is low.

The U.S. Treasury yield curve has been flattening for some time. Risk-averse investors around the world had flocked to the safety of government bonds, such as Treasuries, during the quarter. The flight to perceived safe havens saw two-year and 10-year Treasury yields tumble. The yield on the benchmark 10-year note — widely used in setting borrowing costs for consumers and businesses worldwide — fell below 2% at the end of the reporting period. The yield on the two-year note, which often moves with expectations for Fed policy, dropped to 1.75%.

The spread between the two-year yield and the 10-year yield, a popular gauge of the yield curve's steepness, narrowed to 25 basis points at the end of June 2019. But this relationship has yet to invert, reflecting expectations that the Fed will step in to lengthen the economic expansion, securing a so-called soft landing. A yield curve inversion has been a strong predictor of recessions. Meanwhile, the three-month London Interbank Offered Rate (LIBOR) fell by 28 basis points to 2.32%.

How did the fund perform? What strategies fueled this result?

The fund outperformed its benchmark, the ICE BofAML U.S. Treasury Bill Index, during the period. The fund returned 0.77% versus 0.67% for the ICE BofAML Bill Index for the three months ended June 30, 2019.

All sectors contributed to performance, reflecting continued strength in risky assets. Bank holdings and securitized bonds, including short-term asset-backed securities and collateralized mortgage obligations, were the biggest drivers of performance once again this quarter. The fund continued to be primarily invested in corporate securities and commercial paper [CP], which provided attractive income above short-term Treasury securities. The financial industry typically makes up about half of the fund's exposure. We invest in short-dated assets with maturities of 3.5 years or less, including corporate CP, which makes up approximately 30% of the fund's holdings. Only a small portion of our CP exposure is in banks.

We lengthened the fund's duration a bit during the quarter. Market expectations for interest-rate cuts increased over the period due to dovish Fed commentary at the June meeting and investor caution surrounding trade uncertainty. As such, we expect the Fed to cut rates in the second half of 2019. However, we do not expect interest-rate risk to be a significant driver of returns and/or net asset value [NAV] movements in the fund.

Which strategies detracted from returns?

There were no major detractors this period. Some securitized assets marginally underperformed but had a negligible effect on relative results. Income was slightly lower in the portfolio as floating-rate securities reset their coupons lower when LIBOR declined. Commercial paper rates also dropped. While we strive to maintain a low-volatility NAV, the value does fluctuate. The NAV increased by one penny at the beginning of the quarter and remained steady through the remainder of the period.

What is the outlook for fixed-income markets?

Weaker global economic data, political troubles in the eurozone, anemic inflation, and uncertainty stemming from protectionist tariffs have put pressure on global growth. The U.S. economy is also facing headwinds and is expected to expand at a more moderate pace — albeit still positive — in 2019 compared with that of last year. The Fed expects 2.1% growth this year, down from the 2.3% pace that it forecast in December 2018. We believe inflationary pressures will also remain modest.

The Fed dropped its pledge to remain "patient" before raising or lowering interest rates from its policy statement in June. The Federal Open Market Committee [FOMC], the Fed's policy arm, said in the statement the central bank will "closely monitor'' future economic data and will "act as appropriate'' to maintain the current economic expansion. Market participants are starting to price in multiple rate cuts by the end of 2019.

We expect to see some volatility in fixed-income markets because of uncertainties related to the U.S.–China trade talks and global growth. Washington and Beijing have imposed tariffs on billions of dollars' worth of one another's goods since the start of 2018, battering financial markets and souring business and consumer sentiment. The falling 10-year Treasury yield suggests the U.S. economy isn't humming along as strongly as previously believed. Treasury yields typically rise when investors are confident about the economic outlook

At the same time, additional Treasury issuance — as the deficit widens and the government rebuilds cash balances — could add more upward pressure on short-term yields. In addition, uncertainty surrounding the upcoming debt ceiling may drive volatility in short-term interest rates. Overall, we believe that short-term debt continues to be an attractive investment option for investors seeking income with low volatility. We expect to keep the portfolio conservatively positioned in interest-rate and credit risks because of the uncertain backdrop for trade, growth, and market movements.

Putnam Ultra Short Duration Income Fund (PSDYX)

Annualized total return performance as of 6/30/19

Class Y shares Inception 10/17/11	**Net asset value**	**ICE BofAML U.S. Treasury Bill Index**
Last quarter	0.77%	0.67%
1 year	2.60	2.39
3 years	1.85	1.38
5 years	1.31	0.89
Life of fund	1.16	0.61

Total expense ratio: 0.44%

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 11/30/19.

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.

The ICE BofAML 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.

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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, 2019. 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. You can lose money by investing in the fund.

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