Q4 2020 | Putnam Ultra Short Duration Income Fund Q&A

Bond markets divided on pace of recovery

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The U.S. Treasury yield curve trended higher and slightly steepened during the fourth quarter.

Investment-grade corporate bonds and high-quality securitized assets aided portfolio results.

We are finding value in floating-rate securities over fixed-rate assets, especially those issued by high-quality banks.

How were market conditions in the fourth quarter?

Global financial markets ended the period on a strong note, fueled by the development of COVID-19 vaccines, signs of economic recovery, and a new U.S. stimulus package. Both equities and fixed-income assets rebounded, continuing the market's run from the downturn earlier in the year. The S&P 500 Index, a broad measure of stocks, rose 12.15% during the period. The rate-sensitive Bloomberg Barclays U.S. Aggregate Bond Index advanced 0.67% during the quarter. The ICE BofA 1–3 Year U.S. Corporate Index rose 0.74%.

In late December, U.S. lawmakers approved a $900 billion coronavirus relief package that would send direct payments to many Americans, provide aid to businesses, and fund distribution of the COVID-19 vaccines, among other measures. Meanwhile, the Federal Reserve has kept short-term interest rates near zero since March. It also announced an extension of several lending programs that are supportive of the short end of the curve. At the same time, it decided to let the primary and secondary corporate credit facilities expire at year-end.

The U.S. Treasury yield curve moved higher and steepened somewhat during the period. The 10-year Treasury yield rose quarter over quarter, ending the period at 0.93%, while the yield on the 2-year note ended unchanged at around 0.13%. Elsewhere, high-yield and investment-grade corporate bonds, along with emerging-market debt, outperformed Treasuries during the period. Mortgage credit also enjoyed relative outperformance, albeit more modestly.

Not FDIC insured | May lose value | No bank guarantee

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 returned 0.13% net of fees versus a gain of 0.03% for the benchmark index for the three months ended December 31, 2020.

Corporate credit was the main contributor to the fund's performance over the three-month period. The fund is primarily invested in investment-grade corporate bonds and commercial paper [CP]. Therefore, corporate spread movements tend to have the largest impact on the fund's performance. Following a period of extreme widening in March, corporate credit spreads tightened during the remainder of 2020, albeit at a slower pace in the second half of the year. This served as the main catalyst for the fund's outperformance relative to its benchmark. The Bloomberg Barclays 1–3 Year Index OAS versus Treasuries tightened by 23 basis points (bps) during the fourth quarter and resides at +35 bps as of year-end. Spreads have retraced more than 100% of the widening in March and are now at post-financial crisis tights. Issuer selection within the financials sector, which is the largest sector allocation within the fund, was particularly strong, especially within high-quality bank issuers.

In addition, the fund's allocation to securitized sectors like non-agency residential mortgage-backed securities (RMBS) and asset-backed securities (ABS) contributed to performance. The team increased the portfolio's allocation to AAA-rated credit card and prime auto ABS during the second half of the year, which proved beneficial.

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

The progress on the development of vaccines has reduced the chances of slower economic growth in 2021. However, rising infection rates and shutdowns could lead to weaker-than-expected economic activity in the coming months. In November, several drug makers released positive news about vaccines, including those with efficacy in excess of 90%. In December, the U.S. Food and Drug Administration approved both Pfizer-BioNTech and Moderna's vaccines. The financial markets are now pinning hope on widespread vaccinations by the middle of 2021.

We believe credit markets, supported by the Fed's promise to maintain quantitative easing, will continue to recover. The central bank is committed to aiding the economy by keeping borrowing costs low, pinning short-term interest rates near zero, and buying billions of dollars of bonds. We think bond yields, including Treasury debt, will remain low across the curve for an extended period, but will remain in positive territory.

Direct spending by Congress and the White House will help boost economic growth and consumer spending in the United States. The second coronavirus relief package will provide a fresh infusion of aid to households and small businesses, and for the distribution of vaccines.

What are the fund's strategies going forward?

From a strategy perspective, the portfolio management team is continuing to take a more conservative approach since we believe valuations are less attractive after several months of spread tightening. We are confident about the fund's positioning as we head into 2021. The fund is targeting a duration around 0.30 years, approximately a tenth of a year longer than where it began the past fiscal year. We are finding value in floating-rate instruments over fixed-rate securities, particularly those issued by high-quality banks. Floating-rate securities also can participate in higher rates in the future as the economy recovers from the COVID-19 pandemic.

Within securitized sectors, we are finding opportunities in high-quality assets, including AAA-rated credit card and prime auto ABS. Although we limit the fund's allocation to securitized sectors to approximately 10% of the portfolio, this smaller position has provided diversification benefits and additional incremental yield for the fund. Additionally, we are keeping a balance of short-maturity commercial paper for liquidity. Market liquidity is strong on the front end, but it was a challenging environment to put new money to work in the fourth quarter. CP yields are trading through historical averages, driven by lower supply as many companies issued longer-term debt in replace of commercial paper during the year. With that said, we have begun to see issuers return to the CP market, which may present opportunities going forward.

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 one year or less and in upper-tier investment-grade securities [A or AA rated] maturing in a range of one 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 12/31/20

Class Y shares Inception 10/17/11	**Net asset value**	**ICE BofA U.S. Treasury Bill Index**
Last quarter	0.13%	0.03%
1 year	1.48	0.74
3 years	2.08	1.65
5 years	1.74	1.23
Life of fund	1.26	0.70

Total expense ratio: 0.37%

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 11/30/21.

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 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 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.

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

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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 December 31, 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.

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