Q3 2018 | Putnam Short Duration Income Fund Q&A

Credit strategies and low rate sensitivity buoy fund performance

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What was the market environment during the third quarter of 2018?

Economic conditions remained relatively strong during the July to September period. U.S. gross domestic product [GDP] increased at a 4.2% annualized rate in the second quarter of 2018, and the unemployment rate fell to 3.7% for September. The tax cuts also continued providing stimulus to the U.S. economy. Inflation readings remained tame despite weather-related disruptions in the United States and an uptick in oil prices.

Short-term interest rates continued to increase steadily during the quarter. The Federal Reserve raised rates by 25 basis points in September, the third hike of 2018, and signaled one more increase was likely this year. The September rate increase pushed the funds rate to the range of 2.00% to 2.25%. This rate is closely tied to consumer debt, particularly credit cards, home equity lines of credit, and other adjustable-rate instruments. The Fed is also gradually reducing its $4.5 trillion balance sheet following nearly a decade of quantitative easing. The plan calls for allowing increasing amounts of mortgage and Treasury debt to mature without being reinvested. The quantitative tightening increased to $40 billion during the quarter and will increase to $50 billion in October 2018 and continue at that pace.

The Fed's monetary policy affects the short end of the curve more than longer-term yields. With short-duration yields climbing, the yield curve has flattened. Short-term yields (three years and shorter) rose 25 to 30 basis points and longer-term rates across the rest of the Treasury curve increased a little more than 20 basis points during the third quarter. This dynamic continues to prompt comparisons with previous curve-flattening cycles that have preceded recessions. Overall, interest rates have normalized given the strengthening economy, the Fed's actions, and the market's response.

How did the fund perform? What strategies helped lead to this result?

The fund outperformed its benchmark, the ICE BofAML U.S. 3-Month Treasury Bill Index, during the period. The fund returned 0.58% versus 0.49% for the benchmark ICE BofAML U.S. Treasury Bill Index for the three months ended September 30, 2018.

Short-term securities issued in the financials sector, primarily banks, were the biggest drivers of performance. The financial industry typically makes up about half of the fund's exposure. We typically invest in both short-dated assets with maturities of 3.5 years or less as well as commercial paper [CP] issued by a variety of corporations, but very little of the CP exposure is in banks. All credit sector exposures performed well because of the strength of the U.S. and global economies and improving corporate earnings. These included various sectors of industrials, as well as electric utilities and securitized debt.

We maintained a defensive interest-rate position in the fund given our expectation for higher short-term rates and volatility in the short end of the yield curve involving credit spreads. The Fed has raised rates three times this year, and we expect them to continue to nudge short-term rates higher. The fund benefited from our interest-rate positioning because we maintained very short duration and were cautious about investing in the one- to three-year part of the curve. About 50% of our allocation remains in floating-rate securities, which reset according to changes in the London Interbank Offered Rate [LIBOR]. As rates rise, the coupons reset higher. We continued to maintain 30% to 40% allocation in commercial paper, giving the portfolio flexibility, liquidity, and the ability to react more quickly to the Fed raising rates.

Which strategies detracted from returns?

Our preference for credit sectors rather than U.S. Treasury securities remained beneficial. A handful of issuers detracted from returns. However, the total contribution to underperformance at the issuer level was fractional. As a reminder, while we strive to maintain a low-volatility net asset value [NAV], the NAV does fluctuate.

What is the outlook for fixed-income markets and the short end of the yield curve?

We anticipate a positive market environment over the next year. We expect the Fed to raise rates one more time at year-end 2018 and again in 2019.

The fund has benefited from flows because of low volatility and the absolute level of interest rates. A couple of years ago, investors were getting a little above 0% return on short-term funds, but now the returns are more than 2%. Short-term fixed-income securities are currently very attractive investment options for shareholders, in our view.

U.S. growth is expected to be a bit better in the second half of the year, and inflationary pressures will remain modest. There is policy tightening already built into the second half of 2018 as the Fed steps up the pace of balance sheet reductions in the fourth quarter of the year. At the same time, additional Treasury issuance as the deficit widens and the government rebuilds cash balances could add more upward pressure to short-term yields. This leads us to believe there is an increased risk of overtightening. The other risk to our view would be a downshift in the U.S. economy.

The escalating trade war is also a risk to this view. The damage to the U.S. economy would come through retaliation, with an impact on business confidence and the financial markets. With this backdrop, we expect to keep the portfolio conservatively positioned with regard to both interest-rate and credit risk.

Putnam Short Duration Income Fund (PSDYX)

Annualized total return performance as of 9/30/18

Class Y shares Inception 10/17/11	**Net asset value**	**ICE BofAML U.S. Treasury Bill Index**
Last quarter	0.58%	0.49%
1 year	1.87	1.54
3 years	1.41	0.82
5 years	1.05	0.52
Life of fund	0.99	0.41

Total expense ratio: 0.45%

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 11/30/18.

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.

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.

The views and opinions expressed are those of the portfolio managers of Putnam Short Duration Income Fund as of September 30, 2018. They are subject to change with market conditions and are not meant as investment advice.

Consider these risks before investing: Putnam 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. We may have to invest the proceeds from prepaid investments, including mortgage-backed investments, in other investments with less attractive terms and yields. 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 or industry. 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. 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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Putnam Retail Management

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