Putnam INVESTMENTS

Q1 2022 | Putnam Ultra Short Duration Income Fund Q&A

Bond markets struggle amid rising rates and geopolitical risks

Michael V. Salm
Chief Investment Officer, Fixed Income
Industry since 1989

Joanne M. Driscoll, CFA
Head of Short Term Liquid Markets
Industry since 1992

Michael J. Lima, CFA
Portfolio Manager
Industry since 1997

The Fed's very hawkish turn has set the stage for interest rates to rise to the highest levels since 2008.

The outlook for ultrashort managers continues to improve, as realized yields and future yield expectations have improved meaningfully over the last few months.

We remain confident in fund positioning and continue to have a constructive view moving forward.

Not FDIC insured | May lose value | No bank guarantee

How were market conditions in the first quarter?

It was a challenging quarter for global financial markets, including fixed income securities. The poor performance of bond markets was caused by a myriad of factors, including rising inflation, the Federal Reserve's increasingly hawkish rhetoric, and the war in Ukraine. In mid-March, the Fed lifted the federal funds rate to a range of between 0.25% and 0.50%. The Bloomberg U.S. Aggregate Bond Index — made up largely of U.S. Treasuries, highly rated corporate bonds, and mortgage-backed securities — returned –5.93%. The S&P 500 Index, a broad measure of U.S. stock performance, returned –4.6%.

Fed policymakers also penciled in six more rate increases by year-end, reduced their U.S. growth estimates for the year, and raised inflation expectations. The Fed's latest dot plot, or median projections, show the policy rate rising to around 2.75% by the end of 2023, which would be the highest level since 2008. Yields on some shorter-term Treasuries, such as the 2-year note, have edged above those of longer-term bonds like the 10-year note, creating a flat or inverted yield curve. The yield on the benchmark 10-year U.S. Treasury note rose from 1.63% on January 3 to 2.32% on March 31.

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

The fund underperformed its benchmark, the ICE BofA U.S. Treasury Bill Index, during the period. The fund returned –0.30% on a net basis versus a return of –0.03% for the benchmark index for the three months ended March 31, 2022. A combination of widening credit spreads and rising short-term rates drove relative underperformance in the first quarter.

Corporate credit was the largest detractor from the fund's relative performance, as 1–3 year investment-grade corporate spreads widened meaningfully from historically tight levels. After ending 2021 at +42 basis points, 1–3 year spreads widened out to +89 basis points by mid-March, before retracing part of that move to end the period at +59 basis points, negatively impacting our corporate bond positions. Additionally, the fund's allocation to securitized sectors, including non-agency residential mortgage-backed securities [RMBS] and asset-backed securities [ABS], detracted, albeit marginally. The team continues to focus the portfolio's allocation in this area on highly rated securities that are senior in the capital structure, which we believe provide diversification benefits to our corporate exposure.

On the other hand, our allocations to commercial paper contributed to returns. We keep a balance of short-maturity commercial paper for liquidity. Commercial paper yields have risen to begin the year; as rates have increased, we have been able to reinvest the maturing paper at higher rates. Avoidance of Treasuries contributed to relative returns as well, in an environment where Treasuries sold off and the curve flattened.

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

Ultrashort managers faced a challenging yield environment in 2021. This was exacerbated by the amount of liquidity entering the system driven by unprecedented monetary policy actions, including the Fed's quantitative easing program. However, the outlook for ultrashort managers continues to improve, as realized yields and future yield expectations have improved meaningfully over the last few months. The yields on 2-year and 3-year Treasury notes have risen sharply during the first three months of the year. Additionally, short-term corporate credit spreads [as measured by the Bloomberg U.S. 1-3 Year Corporate Bond Index] have widened over the last few months after reaching all-time tights at the end of the third quarter in 2021.

With the Fed reaching an inflection point and with higher rates on the horizon, we are constructive on the outlook for ultrashort bond funds, and our fund in particular, as we can take advantage of higher interest rates. This should benefit fixed income investors without taking the same level of interest-rate risk as longer-term bond funds.

What are the fund's strategies going forward?

We remain confident in fund positioning and continue to have a constructive view moving forward. We have positioned the fund to take advantage of a higher interest-rate environment. Specifically, we increased the fund's allocation to securities with a floating-rate coupon tied to either LIBOR or SOFR [Secured Overnight Financing Rate], now roughly 60% of the portfolio as of quarter-end. These securities' coupons reset on a daily, 1-month, or 3-month basis to reflect current short-term rates and carry a very short duration [or interest-rate sensitivity]. In a rising-rate environment, this strategy can help the fund participate in increasing yields, without experiencing the negative price effects of longer-duration fixed-rate securities. Additionally, as yields rise, income generation can act as a larger buffer to NAV movements on a total-return basis.

Throughout 2021, we shortened the duration of the fund and have kept the fund's duration relatively static to begin 2022. As of March 31, 2022, the fund's duration is 0.25 years [down 0.13 years from where it began 2021 and roughly equal to the previous quarter-end]. We also continue to structure the portfolio in a manner emphasizing a combination of lower-tier investment-grade securities [BBB or equivalent], generally maturing in 1 year or less, and upper-tier investment-grade securities [A or AA rated], generally maturing in a range of 1 to 3.5 years.

Given the improving valuations on the short end of the curve, we have been able to add some incremental risk to the portfolio but have been judicious in doing so. Capital preservation remains the primary objective of our fund; we do not try to "stretch for yield" in the strategy.

Putnam Ultra Short Duration Income Fund (PSDYX)

Annualized total return performance as of 3/31/22

	Class Y shares Inception 10/17/11	**ICE BofA U.S. Treasury Bill Index**
Last quarter	−0.30%	−0.03%
1 year	−0.24	0.00
3 years	1.07	0.82
5 years	1.41	1.14
10 years	1.09	0.65
Life of fund	1.08	0.62

Total expense ratio: 0.36%

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 11/30/22.

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 U.S. Aggregate Bond Index is an unmanaged index of U.S. investment-grade fixed-income securities. 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. The S&P 500® Index is an unmanaged index of common stock performance. You cannot invest directly in an index.

BLOOMBERG® is a trademark and service mark of Bloomberg Finance L.P. and its affiliates (collectively "Bloomberg"). Bloomberg or Bloomberg's licensors own all proprietary rights in the Bloomberg Indices. Neither Bloomberg nor Bloomberg's licensors approve or endorse this material, or guarantee the accuracy or completeness of any information herein, or make any warranty, express or implied, as to the results to be obtained therefrom, and to the maximum extent allowed by law, neither shall have any liability or responsibility for injury or damages arising in connection therewith.

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 March 31, 2022. 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.®

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 329445 4/22