Q1 2019 | Putnam Short Duration Income Fund Q&A

Higher rates and low volatility keep short-term debt attractive

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The Fed's pause on rates and investor doubts about growth fuel dual stock-bond rally.

Positions in bank credit and short-term asset-backed securities drive performance.

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

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

Global financial markets staged a significant risk rally during the first quarter. The Federal Reserve signaled little appetite for raising interest rates in the near future, boosting U.S. and international equities and sending long-term Treasury yields on a declining streak. U.S. growth appeared to be slowing from last year, under the weight of the Trump administration's trade war, economic slowdowns in Europe and China, and fading stimulus from the tax cuts of 2017. Still, the unemployment rate touched multi-decade lows and inflation remains anchored.

Slowing U.S. economic activity contributed to the Fed's decision in March to pause its three-year campaign to tighten monetary policy. The Fed had raised rates four times in 2018, pushing the federal funds rate to a range of 2.25% to 2.50%. The rate can influence everything from mortgages to credit cards to home equity lines of credit. Fed Chair Jerome Powell also laid out a plan for stemming the reduction of the estimated $4.5 trillion balance sheet that was built up during the 2008 financial crisis. The Fed will begin to taper the runoff from its bond portfolio in May and end it in September. The move is expected to help hold down long-term rates.

Not FDIC insured | May lose value | No bank guarantee

The U.S. Treasury market continued to draw headlines. One- and 3-month Treasury bill yields remained mostly unchanged, while the 3-month London Interbank Offered Rate [LIBOR] fell by about 20 basis points during the period. The yields on 1-, 2-, and 3-year notes fell between 20 to 26 basis points, furthering the yield curve inversion. The widely watched spread between 2- and 10-year notes narrowed slightly to around 14 basis points. The inversion of the yield curve can be a signal of a recession on the horizon, but we do not believe a recession is imminent.

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 0.88% versus 0.62% for the ICE BofAML U.S. Treasury Bill Index for the three months ended March 31, 2019.

All sectors contributed to performance, reflecting the strong rally in risk assets. Bank holdings and securitized bonds, including short-term asset-backed securities and collateralized mortgage obligations, were the biggest drivers of performance. The fund continued to be primarily invested in corporate securities and commercial paper [CP], which provided positive carry. 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. Only a small portion of our CP exposure is in banks.

We maintained a defensive interest-rate position because we expected higher volatility in the front end of the yield curve. This was due to uncertainty at the beginning of the quarter about the Fed's monetary policy and the status of U.S.-China trade talks. We expect the Fed to hold rates steady in the near term. Commercial paper continued to make up about 40% of the fund's holdings, giving the portfolio flexibility and liquidity.

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. While we strive to maintain a low-volatility net asset value [NAV], the NAV does fluctuate. The NAV regained two pennies given the risk-on rally, reversing two-thirds of the NAV change in the fourth quarter of 2018.

What is the outlook for fixed-income markets?

The global economy continues to slow. Higher real rates, weaker demand from China, political troubles in the eurozone, and protectionist tariffs continue to weigh on growth. The U.S. economy is also facing rising headwinds and is expected to expand at a more moderate pace in 2019 compared with last year. The Fed expects 2.1% growth this year, down from the 2.3% it forecast in December. We believe inflationary pressures will remain modest.

The Fed's Powell said in March that interest rates could be on hold for "some time" as global risks weigh on the economic outlook and inflation remains muted. In December 2018, Fed officials said they expected two rate increases this year and another in 2020. They now project one rate hike in 2020 and none in 2021. We expect to see some volatility in fixed-income markets as growth momentum slows. 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.

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 Short Duration Income Fund (PSDYX)

Annualized total return performance as of 3/31/19

Class Y shares Inception 10/17/11	**Net asset value**	**ICE BofAML U.S. Treasury Bill Index**
Last quarter	0.88%	0.62%
1 year	2.37	2.17
3 years	1.70	1.19
5 years	1.20	0.76
Life of fund	1.09	0.54

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 Short Duration Income Fund as of March 31, 2019. 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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