Q4 2018 | Putnam Short Duration Income Fund Q&A

Securitized and short-term credit buoyed performance

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We maintained a defensive interest-rate position given expectations for higher short-term rates and volatility.

The Fed will continue to raise its benchmark interest rate in 2019, albeit at a slower pace.

U.S. economic growth will likely moderate amid rising rates and waning fiscal stimulus.

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

The U.S. economy remained strong but interest rates, market volatility, and global trade tensions increased. Buoyed by government spending and tax cuts, the U.S. economy grew at a 3.5% annual rate in the third quarter of 2018, after expanding 4.2% in the second quarter. Unemployment has touched multi-decade lows, inflation remains anchored around 2%, and the likelihood of a recession remains low.

Short-term interest rates increased steadily during the quarter. The Federal Reserve raised its benchmark rate in December, the fourth hike of 2018, and the ninth since the Fed began normalizing policy in December 2015. The December rate hike pushed the federal funds rate to a range of 2.25% to 2.50%. This rate closely ties to consumer debt, home equity lines of credit, and other adjustable-rate instruments. The Fed is also gradually reducing its $4.5 trillion balance sheet following a decade of quantitative easing. The plan calls for allowing increasing amounts of mortgage and Treasury debt to mature without being reinvested.

Not FDIC insured | May lose value | No bank guarantee

Short-term Treasury yields and other short-term interest rates, such as the London Interbank Offered Rate [LIBOR], rose during the period. However, longer-term Treasury yields fell. The widely watched spread between two- and 10-year Treasury yields narrowed to around 21 basis points at the end of the quarter. The flattening of the yield curve can be a sign that bond investors expect the economy to slow. Higher rates also create headwinds for fixed-income assets. The yield on the benchmark 10-year note traded around 2.73%, while the two-year yield held at around 2.53% at year-end 2018. Bond yields move inversely to prices.

How did the fund perform? What strategies led to this result?

The fund underperformed its benchmark, the ICE BofAML U.S. Treasury Bill Index, during the period. The fund returned 0.34% versus 0.58% for the ICE BofAML Bill Index for the three months ended December 31, 2018.

Holdings in securitized sectors, including short-term asset-backed securities and collateralized mortgage obligations, were the biggest drivers of performance. Securitized assets were less volatile than corporate securities toward the end of the quarter. The fund continued to be primarily invested in corporate securities and commercial paper [CP], which provided positive carry. Securities in the financial industry typically make up about half of the fund's exposure. We invest in short-dated assets with maturities of 3.5 years or less, including commercial paper issued by companies across various sectors. Only a small portion of our CP exposure is in banks.

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. We expect the Fed to continue to nudge interest rates higher, albeit at a slower pace relative to 2018. About 50% of our allocation remains in floating-rate securities, which reset according to changes in LIBOR. As rates rise, the coupons reset higher. This helped performance because the three-month LIBOR rose by 0.40% during quarter. Commercial paper made up about 40% of the fund's holdings, giving the portfolio flexibility, liquidity, and the ability to react more quickly to the Fed raising rates.

Which strategies detracted from returns?

Our exposure to several highly rated banks detracted because of challenging market technicals. But the banking sectors' fundamentals remained solid. In addition, some of our holdings in the energy sector detracted from returns as oil prices fell by $30 a barrel in the fourth quarter. While we strive to maintain a low-volatility net asset value [NAV], the NAV fluctuates at times.

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

The outlook for global growth in 2019 has slipped because of rising interest rates, trade disputes, and asset market volatility. The U.S. economy will expand at a more moderate pace in 2019 compared with last year as the impact of the year-end 2017 corporate tax cut fades. Additionally, we believe inflationary pressures will remain modest. Fed Chair Jerome H. Powell December acknowledged at the December rate meeting that the economy is showing signs of "softening."

Market volatility may continue as growth momentum slows and the Fed becomes more restrictive. We expect the Fed to slow the pace of interest-rate increases and continue reducing its balance sheet in the first quarter of 2019. 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. This leads us to believe there is an increased risk of overtightening.

The fund has benefited from higher interest rates. Before the Fed began its interest-rate hiking cycle, the return on short-term funds was a little above zero percent. Now, yields have eclipsed 2.5%. 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 an uncertain backdrop of monetary policy, trade, and market movements.

Putnam Short Duration Income Fund (PSDYX)

Annualized total return performance as of 12/31/18

Class Y shares Inception 10/17/11	**Net asset value**	**ICE BofAML U.S. Treasury Bill Index**
Last quarter	0.34%	0.58%
1 year	1.93	1.88
3 years	1.47	1.02
5 years	1.06	0.64
Life of fund	1.01	0.47

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 December 31, 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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