Q3 2020 | Putnam Ultra Short Duration Income Fund Q&A

Fed programs continue to support short-term fixed income

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U.S. Treasury yields hover near lows amid pandemic and legislative impasse on a new stimulus package.

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

We believe short-term securities will remain an attractive safe-haven investment as we head into the fourth quarter.

How were market conditions in the third quarter?

Global financial markets ended the period on a strong note. The rally was fueled by ongoing stimulus policies, signs of economic revival, and progress toward a COVID-19 vaccine. All three major U.S. stock indexes turned in a second consecutive quarter of gains, continuing the equity market's historic run from the downturn earlier in the year. The market's resilience also benefited bondholders. The rate-sensitive Bloomberg Barclays U.S. Aggregate Bond Index advanced 0.62% during the quarter. The ICE BofA 1–3 Year U.S. Corporate Index rose 0.74%.

In August, the Fed announced a new monetary policy framework that will essentially abandon its longtime strategy of preemptively lifting rates to head off higher inflation. The Fed's shift in how it sets rates indicates the central bank will tolerate "lower for longer" policy easing. Central banks across Europe, Asia, and other regions also rolled out COVID-19 stimulus measures. Still, investors remain concerned about low global growth, spikes in COVID-19 cases, and the November U.S. presidential elections.

The Fed continues to make it clear that interest rates will remain low for a while; thus, Treasury yields were range bound during the quarter, with the 10-year Treasury ending almost unchanged quarter over quarter at 0.68%. Meanwhile, the yield on the 2-year note ended the quarter around 0.13%. The market for high-yield and investment-grade corporate bonds continued to recover as spreads, or the risk premiums investors demand to hold these securities over U.S. Treasuries, narrowed during the period.

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 rose 0.35% versus a gain of 0.04% for the benchmark index for the three months ended September 30, 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], so 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 dramatically in the second quarter and continued to tighten in the third quarter, albeit at a slower pace. 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 15 basis points (bps) during the third quarter and resides at +58 bps as of end September; spreads have retraced approximately 95% since March. 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 quarter, which proved beneficial. We limit our allocation to securitized sectors to a maximum of 10% of the portfolio, but this smaller allocation within the fund proved to be beneficial.

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

The U.S. economy continues its slow recovery from the sharp decline in the second quarter. The development of a vaccine or vaccines for COVID-19 could help provide a boost to economic growth and consumer spending. That said, we believe the risk of renewed widespread lockdowns is low. Politics will take center stage over the next few months, including the legislative gridlock on a new stimulus package. Democrats and Republicans have been at an impasse over the next virus relief bill since talks broke off in early August. In addition, the U.S. presidential election campaigns will kick into full gear over the next few weeks. That has the potential to create asset market volatility.

Despite uncertainty surrounding the elections and the virus, Putnam's fixed income team has a positive outlook on the fixed-income markets. We believe the Fed continues to understand the importance of the funding markets to the broader fixed-income landscape. Usage of the Fed's facilities, including the money market liquidity facility, the commercial paper funding facility, and the corporate credit facilities, has been relatively low thus far. However, these facilities will continue to serve as an important backstop for the financial markets in the event of future market stress. Fed officials expect to leave rates near zero for years — through at least 2023 — as they try to coax the economy back to full strength after the pandemic-induced recession. We think bond yields, including Treasury debt, will remain low across the curve for an extended period but will remain in positive territory.

What are the fund's strategies going forward?

From a strategy perspective, the portfolio management team is taking a more conservative approach this time, as spreads have tightened significantly over the past five months on the heels of Fed intervention. We are confident about the fund's positioning as we head into the fourth quarter. The fund is targeting a duration of 0.30–0.35 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. Also, we are finding opportunities in high-quality securitized assets, including AAA-rated credit card and prime auto ABS. Additionally, we are keeping a balance of short-maturity commercial paper for liquidity, although we have been less active deploying new money there. Market liquidity is strong on the front end, but it's a challenging environment to put new money to work at current low yields.

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 1 year or less and in upper-tier investment-grade securities [A or AA rated] maturing in a range of 1 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 9/30/20

Class Y shares Inception 10/17/11	**Net asset value**	**ICE BofA U.S. Treasury Bill Index**
Last quarter	0.35%	0.04%
1 year	1.89	1.19
3 years	2.14	1.73
5 years	1.76	1.22
Life of fund	1.28	0.72

Total expense ratio: 0.38%

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 11/30/20.

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.

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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 September 30, 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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