Strategy exhibits stability despite Fed and economic uncertainty

How were market conditions in the second quarter?

Market conditions were mixed. Fixed income rallied in April 2023. Even as a U.S. recession remained a possibility, expectations about the future path of the Federal Reserve’s monetary policy changed. Investors hoped a continued economic slowdown might give the Fed room to ease monetary policy.

In May, fixed income encountered headwinds. Lingering concerns about the failure of a few regional banks in March 2023, the U.S. debt ceiling, and higher U.S. Treasury rates weighed on investor sentiment. At its May 2023 meeting, the Fed raised its benchmark interest rate by 0.25% to a range of 5.00%–5.25%. In its commentary, the Fed suggested that future interest-rate hikes would be dependent on the effect of past rate hikes on the economy. In late May, Congress and the White House agreed to a debt ceiling deal.

In the final weeks of the quarter, sentiment improved. A cooler-than-expected inflation reading for May 2023 led to expectations that the Fed might hold interest rates steady at its June meeting. At that meeting, the Fed skipped an interest-rate hike to allow time to assess the effects of its monetary policy and to potentially avoid tipping the U.S. economy into a recession. Fed policymakers added that two more interest-rate hikes remained a possibility this year.

The yield on the 2-year U.S. Treasury note began the period at 4.06% and rose to 4.74% on June 27, before closing the quarter at 4.06%. The yield on the benchmark 10-year Treasury note began the period at 3.48% and climbed as high as 3.84% on June 13, before ending the quarter at 3.81%.

The fund outperformed its benchmark, and its distribution yield increased by 18 basis points to end the quarter at 4.96%.

Corporate credit was the largest contributor to the fund’s relative performance during the quarter, particularly issuer selection within financials.

We continue to believe that interest-rate cuts in 2023 are unlikely due to a resilient labor market and sticky core inflation.

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Not FDIC insured | May lose value | No bank guarantee
How did the fund perform? What were the drivers of performance during the period?

The fund outperformed its benchmark, the ICE BofA U.S. Treasury Bill Index, during the period. The fund returned 1.41% on a net basis versus a return of 1.15% for the benchmark index for the three months ended June 30, 2023. Short-term yields also rose throughout the quarter. The fund’s distribution yield increased by 18 basis points [bps] to end the quarter at 4.96%. The fund’s NAV finished the quarter at $10.03, two pennies higher than where it began.

Following spread volatility amid stresses within parts of the banking sector in March 2023, short-term corporate credit spreads stabilized and then tightened in the second quarter. After beginning the quarter at 101 bps, the Bloomberg U.S. 1-3 Year Corporate Bond Index’s spread to Treasuries tightened to end the quarter at 72 bps. This aided returns, as the fund is primarily invested in short-term corporate securities.

Corporate credit was the largest contributor to the fund’s relative performance during the quarter. Issuer selection within financials, which is the largest sector allocation within the fund, was strong. The portfolio’s allocation to industrial sectors, such as automotives, proved beneficial during the quarter as well.

Our allocations to commercial paper contributed to returns as well. We keep a balance of short-maturity commercial paper for liquidity. Commercial paper yields continued to rise during the quarter. As interest rates increased, we have been able to reinvest the maturing paper at higher rates.

Lastly, the fund’s allocation to securitized sectors, including non-agency residential mortgage-backed securities and asset-backed securities, augmented performance, albeit modestly. The portfolio management team continues to focus allocations in this area on highly rated securities that are senior in the capital structure, which provides diversification within our corporate exposure.

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

In the aftermath of the Fed’s decision to skip a rate hike at its June meeting, we believe future monetary policy decisions will be influenced by incoming economic data. We continue to believe that interest-rate cuts in 2023 are unlikely due to a resilient labor market and sticky core inflation.

Credit spread volatility will likely stay elevated in 2023, as the market continues to digest tighter financial conditions. Current spread levels are well inside typical recessionary levels. As such, we are maintaining a conservative approach and focusing on issuers with strong fundamentals that we believe are appropriately priced for implied Fed activity.

We expect balance sheets for the banking sector to remain stable, particularly within the larger “national champion” banks that dominate that exposure in the fund. We believe most banks will continue to maintain levels of capitalization at or above long-term targets. Meanwhile, current asset quality profiles remain on solid footing, in our view, helping these institutions to weather this potentially more challenging period.

What are the fund’s strategies going forward?

We have positioned Putnam Ultra Short Duration Income Fund to take advantage of a sustained higher interest-rate environment, as we believe Fed cuts in 2023 are unlikely. The fund holds a meaningful allocation to securities with a floating-rate coupon tied to the Secured Overnight Financing Rate. These securities’ coupons reset periodically to reflect current short-term rates. With that said, given our belief that we are nearing a pause in the Fed’s hiking cycle, we marginally extended the fund’s duration during the quarter by purchasing fixed-rate securities. After beginning the quarter with a duration of 0.35 years, the fund ended the quarter with a duration of 0.41 years.
From a credit quality standpoint, the portfolio is structured with a combination of lower-tier investment-grade securities [BBB or equivalent], generally maturing in one year or less, and upper-tier investment-grade securities [A or AA rated], generally maturing in a range of 1 to 4 years. Within investment-grade corporates, we continue to have a high level of confidence in the creditworthiness of our banking exposure despite the banking turmoil experienced in March 2023. We believe the names we own can hold up well, even in a deteriorating economic environment.

Overall, the Ultra Short Duration Income team is actively monitoring portfolio exposures as market events evolve. We continue to structure the portfolio with capital preservation and liquidity as the primary objectives. We do not try to “stretch for yield” in the strategy.

Putnam Ultra Short Duration Income Fund (PSDYX)
Annualized total return performance as of 6/30/23

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<thead>
<tr>
<th></th>
<th>Class Y shares</th>
<th>ICE BofA U.S. Treasury Bill Index</th>
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<tbody>
<tr>
<td>Inception 10/17/11</td>
<td></td>
<td></td>
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<tr>
<td>Last quarter</td>
<td>1.41%</td>
<td>1.15%</td>
</tr>
<tr>
<td>1 year</td>
<td>4.25%</td>
<td>3.59%</td>
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<tr>
<td>3 years</td>
<td>1.43%</td>
<td>1.24%</td>
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<tr>
<td>5 years</td>
<td>1.81%</td>
<td>1.56%</td>
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<tr>
<td>10 years</td>
<td>1.40%</td>
<td>1.00%</td>
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<tr>
<td>Life of fund</td>
<td>1.31%</td>
<td>0.87%</td>
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</tbody>
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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 11/30/23.

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. 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 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 June 30, 2023. 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.

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.

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