Q4 2017 | Putnam Short Duration Income Fund Q&A

Shorter maturities lead rate normalization

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Short-end rates continue to lead the yield-curve flattening.

Fed likely to stay the course, barring the unexpected.

Fed leadership changes signal policy stability.

Please describe fixed-income market conditions in the quarter.

Short-term rates continued to increase steadily during the quarter, ending significantly higher for the year. As generally expected, the Federal Open Market Committee [FOMC] raised rates 25 basis points at its December meeting, the third such increase in 2017. The yield curve continued to flatten, with the 10-year rates mostly unchanged for the fourth quarter and the calendar year, but the 30-year Treasury yield lower by 12 and 33 basis points for the quarter and calendar year, respectively. This dynamic prompted comparisons to previous curve flattening cycles that have preceded recessions, in particular the last round of Federal Reserve tightening before the 2008 financial crisis. In our view, these concerns are not warranted considering current economic conditions and the range of factors contributing to what is essentially rate normalization. Strong institutional demand for longer-maturity bonds has helped to stabilize yields, and the Fed is just beginning to unwind its long-term holdings. At the same time, demand for Treasury bills, coupled with central bank actions, has pressured the short end of the curve. It is not particularly unusual for the long end of the curve to lag under these circumstances, in our view.

Economic conditions remained solid during the quarter, with U.S. gross domestic product [GDP] readings surpassing 3% quarter over quarter and the unemployment rate steadying at just over 4%. Inflation readings remained tame in spite of third-quarter weather-related disruptions in the United States and an uptick in oil prices.

The fund outperformed its benchmark, the ICE BofAML U.S. Treasury Bill Index, during the period. What strategies or factors helped lead to this result?

The fund returned 0.28% versus 0.25% for the benchmark for the three months ended December 31, 2017. During the quarter, we kept the fund positioned defensively with respect to the continued increases in short-term rates, and we maintained the fund's very short duration. Holdings in banking issuers added the most value during the quarter; however, compared with recent quarters, fund returns were marginally lower across sectors.

Which strategies detracted from returns?

As a result of a continued rise in short-term rates and tightening of fixed-income spreads, fund returns within financials and commercial paper holdings drove return, while positioning in retail was marginally negative for the quarter. During the quarter, the fund did not hold U.S. Treasury bills, which are the basis of the fund's benchmark. Our preference for non-benchmark sectors was still beneficial, but less so than in recent quarters. The net asset value [NAV] of the fund ended the quarter lower by one penny. While we strive to maintain the fund's NAV, the NAV does float, in this case reflecting short-term rate factors present during the past several months.

What is your outlook for fixed-income markets?

As inflation rates have remained subdued, one question is whether wage pressures or commodity prices may increase enough to make a difference. The Fed is indicating a continuation of the recent pace of rate hikes, but should inflation spike, the Fed may tighten more aggressively. Our current expectation is to see three or four rate increases in 2018. We also expect an increase in Treasury bill issuance, but that demand will be enough that this will not further pressure rates higher.

We do not anticipate significant changes in Fed policy with the appointment of new chair Jerome Powell. In addition to Janet Yellen leaving the Fed, we are also losing some experience in Stan Fischer, as well as in William Dudley, both fairly senior members of the board. We expect a meaningful but stable transition. Based on the December 2017 FOMC notes, the Fed is still somewhat divided as to potential risks to its outlook, and continues to prefer a moderate approach to raising rates directly.

We expect the Fed's rate normalization to continue at the front end of the curve. Longer rates have been somewhat stable, but that could change if the market views the central banks as moving too slowly given the global state of economic activity overall. Instability in the stock market or the high-yield bond sector could cause rates to fall back in the interim. Ultimately, whether the curve is slightly steeper or flatter, we expect 2018 to look much like 2017, which in our view means continued good economic performance globally and slightly higher movement of rates overall.

Putnam Short Duration Income Fund (PSDYX)

Annualized total return performance as of 12/31/17

Class Y shares Inception 10/17/11	Net asset value	ICE BofAML U.S. Treasury Bill Index
Last quarter	0.28%	0.25%
1 year	1.39	0.81
3 years	0.95	0.42
5 years	0.83	0.28
Life of fund	0.86	0.25

Total expense ratio: 0.45%

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 11/30/18.

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 BofA ML 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.

The views and opinions expressed are those of the portfolio managers of Putnam Short Duration Income Fund as of December 31, 2017. 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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