Q3 2017 | Putnam Short Duration Income Fund Q&A

Inflation remains the wild card in the Fed's hand

Michael V. Salm
Co-Head of Fixed Income
Industry since 1989

Joanne M. Driscoll, CFA
Portfolio Manager
Industry since 1992

Emily E. Shanks
Portfolio Manager
Industry since 1999

Short-end rates continue to inch higher.

The Fed remains cautious with balance sheet reduction in play.

FOMC membership changes may affect policy.

Please describe fixed-income market conditions in the quarter.

Many of the dynamics established during the second quarter extended through the third. This included a continuing flattening of the yield curve as short-term rates maintained their upward momentum and longer rates traded in a range, with the 10-year yield beginning and ending the quarter essentially flat. Revised second-quarter gross domestic product growth increased at an annual rate of 3.1%, the strongest quarterly increase since first-quarter 2015. There was little change to economic outlooks until a dramatic hurricane season commenced in mid-August, causing what are likely to be extended disruptions in the regions affected and a potential uptick in inflation, which remained below 2% for the quarter.

After raising rates 25 basis points at its June meeting, the Federal Open Market Committee [FOMC] met in July and September without taking further direct rate action. This was what markets had anticipated. Investors had grown more interested in learning the details of how the Federal Reserve intends to begin unwinding its $4 trillion balance sheet amassed since the 2008 financial crisis. The selling of fixed-income assets owned by the Fed will increase supply, which in turn likely creates pricing pressure resulting in higher rates. The Fed has indicated that this process will be measured and lengthy, with $10 billion initially being liquidated on a monthly basis. The Fed's lack of urgency has been supported by tame inflation readings, and its desire to not repeat the events of

June 2013, when hints of aggressive action set off the "taper tantrum" and a dramatic increase in longer-term rates. At the same time, were inflation to spike, we expect the Fed response to be more aggressive than it has been to date.

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

The fund returned 0.44% versus 0.26% for the benchmark for the three months ended September 30, 2017. We have kept the fund positioned to benefit from the rising rates we have seen three times since December 2016. Roughly half the fund is in floating-rate instruments, and as LIBOR [London Interbank Offered Rate] continued to rise in tandem with Fed funds, the fund benefited. In addition, we maintained the fund's very short duration and ongoing increases in short-end rates were not detrimental to results during the quarter.

Although changes to money market regulations have been in effect for nearly a year, the fund continues to benefit from the higher yields available in the sectors in which the fund invests. Along with allocations to commercial paper, one of the biggest drivers of performance for the quarter continued to be financials. Banks' balance sheets and liquidity positions are stronger than they have been since pre-crisis levels, and this benefited the fund during the quarter. Holdings in food, technology, integrated energy, and electric utilities were also positive contributors, as was the automotive subsector, though less so than in previous quarters.

Did any strategies detract from returns?

Although the fund did not hold U.S. Treasury securities — the basis of the fund's benchmark — during the quarter, this strategy did not actually detract from the fund in real terms. Because the maturities of the fund holdings are so short, averaging less than a year, changes to the values of specific securities tend to be minimal. The net asset value of the fund ended the quarter up a basis point.

What is your outlook for fixed-income markets?

While global economies have been solid, and actions by central banks have been measured, there are plenty of unknowns present. One is how rapidly the central banks in Japan and Europe will evolve their policies, and how that will affect international demand for U.S. Treasuries, which has been high because of lower rates in other developed countries. Given the number of vacancies, the composition of the Federal Reserve Board as well as whether Janet Yellen will stay on as chair, are two important questions. We do not know whether current policy will be supported by new Fed members. Another consideration is the Trump administration's goals in terms of the fiscal front. Tax reform is a big topic for investors to consider. Will there be an increase in the amount of debt in the market?

Aside from these questions, we know that real rates in the United States are too low relative to current economic conditions and historic norms. We also know inflation is lower than the Fed and the other global central banks want it to be. By these measures alone, we can anticipate a gradual move higher. Our belief is that markets can tolerate a gradual increase on the order of 30 to 50 basis points on 10-year rates if this happens slowly, and we do not anticipate a big move in rates before the end of 2017. In any event, we intend to maintain the very short relative duration of the fund, which we believe gives us the flexibility to adjust to market events that may be unexpected.

Putnam Short Duration Income Fund (PSDYX)

Annualized total return performance as of 9/30/17

Class Y shares Inception 10/17/11	**Net asset value**	**BofA Merrill Lynch U.S. Treasury Bill Index**
Last quarter	0.44%	0.26%
1 year	1.34	0.64
3 years	0.86	0.34
5 years	0.83	0.24
Life of fund	0.85	0.22

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 11/30/17.

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 BofA Merrill Lynch 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. The index data referenced herein is the property of Merrill Lynch, Pierce, Fenner & Smith Incorporated ("BofAML") and/or its licensors and has been licensed for use by Putnam Investments. BofAML and its licensors accept no liability in connection with its use. See prospectus for a full copy of the Disclaimer.

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 September 30, 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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Putnam Investments | One Post Office Square | Boston, MA 02109 | putnam.com

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